

September 29, 2006



# Acquisition

## Commercial Contract for Noncompetitive Spare Parts With Hamilton Sundstrand Corporation (D-2006-122)

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### Acronyms

ADQ	Annual Demand Quantity
ALC	Air Logistics Center
CPARS	Contractor Performance Assessment Reporting System
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DLA	Defense Logistics Agency
DSCC	Defense Supply Center, Columbus, Ohio
DSCP	Defense Supply Center, Philadelphia, Pennsylvania
DSCR	Defense Supply Center, Richmond, Virginia
FAR	Federal Acquisition Regulation
FARA	Federal Acquisition Reform Act of 1996
FASA	Federal Acquisition Streamlining Act of 1994
GAO	Government Accountability Office
LANTIRN	Low Altitude Navigation and Targeting Infrared for Night System
NSN	National Stock Number
OEM	Original Equipment Manufacturer
OIG	Office of Inspector General
PBA	Price-Based Acquisition
TINA	Truth in Negotiations Act
USD(AT&L)	Under Secretary of Defense for Acquisition, Technology, and Logistics



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September 29, 2006

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,  
TECHNOLOGY, AND LOGISTICS  
ASSISTANT SECRETARY OF THE AIR FORCE  
(ACQUISITION)  
COMMANDER, OGDEN AIR LOGISTICS CENTER

SUBJECT: Report on the Commercial Contract for Noncompetitive Spare Parts With  
Hamilton Sundstrand Corporation (Report No. D-2006-122)

We are providing this report for review and comment. We considered management comments on a draft of this report in preparing the final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The Under Secretary of Defense for Acquisition, Technology, and Logistics comments were responsive to the recommendations. However, the Assistant Secretary of the Air Force (Acquisition) comments were generally nonresponsive. We request additional comments from the Assistant Secretary of the Air Force on Recommendations B.1.c, B.2, B.2.a, B.2.b, B.2.e, B.2.f, and B.2.h. through B.2.k. by October 30, 2006. If possible, please send management comments in electronic format (Adobe Acrobat file only) to [Joseph.Bucsko@dodig.mil](mailto:Joseph.Bucsko@dodig.mil). Copies of the management comments must contain the actual signature of the authorizing official. We cannot accept the / Signed / symbol in place of the actual signature.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. Henry F. Kleinknecht at (703) 604-9324 (DSN 664-9324) or Mr. Joseph P. Bucsko at (703) 604-9337 (DSN 664-9337). See Appendix D for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

A handwritten signature in black ink, reading "Richard B. Jolliffe", is positioned above the printed name.

Richard B. Jolliffe  
Assistant Inspector General  
Acquisition and Contract Management

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## Department of Defense Office of Inspector General

Report No. D-2006-122

(Project No. D2005-D000CH-0183.000)

September 29, 2006

### Commercial Contract for Noncompetitive Spare Parts With Hamilton Sundstrand Corporation

#### Executive Summary

**Who Should Read This Report and Why?** DoD acquisition and contracting personnel should read this report because it concerns the rapidly increasing cost of noncompetitive spare parts for Defense weapon systems.

**Background.** Hamilton Sundstrand is a subsidiary of United Technologies Corporation. Hamilton Sundstrand designs and manufactures aerospace systems for commercial, regional, corporate, and military aircraft, and is a major supplier for international space programs. Hamilton Sundstrand's aerospace business units provide technologically advanced systems, components, and services for the commercial and military aerospace and related industries.

Over the past 9 years, the DoD Office of Inspector General has worked closely with the Defense Logistics Agency (DLA) and other DoD Components to achieve fair pricing for noncompetitive items. We have issued a series of reports involving the pricing of both commercial and noncommercial spare parts. Two previous reports have discussed the reasonableness of prices paid for spare parts procured from Sundstrand (now Hamilton Sundstrand Corporation) and the company's exclusive distributor, AAR Defense Systems. See Appendix B for a list of prior reports.

In 2004, the Commanders of the Air Force Materiel Command and the Army Materiel Command and the Director, DLA chartered a strategic supplier alliance with Hamilton Sundstrand Corporation. Ogden Air Logistics Center served as the Air Force lead with overall responsibility for the contract and the Defense Supply Center Richmond served as the DLA lead providing pricing support (Air Force negotiating team). The agreement resulted in a 9-year \$860 million strategic sourcing commercial contract for noncompetitive spare parts used on Defense weapon systems. Phase 1 of the contract includes items such as generators and gear boxes and component parts used mostly on the F-16 aircraft. DoD funded approximately \$3.1 billion for research, development, test, and evaluation for the F-16 aircraft.

**Results.** The Air Force negotiating team used questionable commercial item determinations that exempted Hamilton Sundstrand from the requirement to submit cost or pricing data (Truth in Negotiations Act [section 2306a, title 10, United States Code]) on an \$860 million commercial contract for noncompetitive spare parts used on Defense weapon systems. The Air Force also did not establish an effective means to determine price reasonableness of the exempt "commercial" items. As a result, the Air Force negotiating team classified basically all Hamilton Sundstrand noncompetitive spare parts as exempt commercial items and relied primarily on price analysis of previous Government prices that had been determined not to be fair and reasonable by DLA and

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on previous audits. This strategy places the Government at high risk of paying excessive prices and profits and precludes good fiduciary responsibility for DoD funds (finding A).

We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics develop and issue guidance in the Acquisition Regulations to clarify exceptions to cost or pricing data for noncompetitive commercial items and clarify pricing of noncompetitive commercial items as required by the Strom Thurmond National Defense Authorization Act of Fiscal Year 1999. We also recommend that the Under Secretary address whether unreasonable and uncooperative contractors should receive unsatisfactory out-of-cycle ratings in the Contractor Performance Assessment Reporting System.

The Air Force negotiating team used a high-risk pricing strategy that relied primarily on the price analysis of questionable Government prices to price noncompetitive spare parts on the strategic sourcing commercial contract with Hamilton Sundstrand. As a result, we calculated that negotiated price-based prices were about 28.4 percent higher than previous contract prices (adjusted for inflation) for 93 items with an annual demand of more than \$7.5 million. We also calculated that price-based contract prices for two items with an annual value of \$1.4 million were \$950,283 (214.2 percent) higher than cost-based prices (finding B).

We recommend that the Assistant Secretary of the Air Force (Acquisition) initiate action to develop alternate sources for noncompetitive Hamilton Sundstrand items. We also recommend that the Assistant Secretary report the basis of commercial items determinations and steps taken to ensure price reasonableness for all commercial contracts with an estimated value of \$15 million or more annually to the Secretary of Defense as required by the National Defense Authorization Act of Fiscal Year 2003. We also recommend that the Assistant Secretary provide assistance to the contracting officer in obtaining necessary data to determine price reasonableness. We recommend that the Commander, Ogden Air Logistics Center, Hill Air Force Base, Utah, terminate the pricing strategy and address the pricing issues identified in the report with the commercial strategic sourcing contract with Hamilton Sundstrand.

**Management Comments and Audit Response.** We received comments from the Director, Defense Procurement and Acquisition Policy, Under Secretary of Defense for Acquisition, Technology, and Logistics; and the Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition). The Director, Defense Procurement and Acquisition Policy concurred with the report findings and recommendations. The Director will meet with Senior Procurement Executives; deliberate a Federal Acquisition Regulation case; revise procedures and guidance; re-energize the cost analysis and pricing function; and revise the contract pricing reference guide to satisfy the recommendations.

The Military Deputy, Office of the Assistant Secretary of the Air Force, concurred or partially concurred with the report findings and recommendations. On September 28, 2006, the Deputy Assistant Secretary (Contracting), Assistant Secretary (Acquisition) provided technical corrections to the initial Air Force response that resolved some issues. However, management comments overall did not meet the intent of the recommendations regarding the commercial pricing strategy for items on the current and future phases of the contract. Therefore, we request that the Assistant Secretary of the Air Force (Acquisition) provide comments to the final report on Recommendations B.1.c, B.2, B.2.a, B.2.b, B.2.e, B.2.f, and B.2.h. through B.2.k. by October 30, 2006.

We have fundamental differences with the Air Force on the commercial pricing strategy used to procure noncompetitive items for Defense weapon systems. These differences are similar to those identified in DoD Inspector General Report No. D-2004-064, "Acquisition of the Boeing KC-767A Aerial Refueling Tanker," March 29, 2004. Specifically, we do not believe it is appropriate to:

- grant a commercial item exception to cost or pricing data for noncompetitive items if the contractor does not have sufficient commercial sales to support price reasonableness by price analysis of the commercial sales. The appropriate contract type should be a Federal Acquisition Regulation Part 15 contract. The fact that a contractor refuses to negotiate a Federal Acquisition Regulation Part 15 contract is not sufficient justification to award a Federal Acquisition Regulation Part 12 commercial contract.
- use price analysis of previous Government buys to determine price reasonableness for noncompetitive items unless the reasonableness of the previous buy can be established (for example, a previous buy was determined reasonable based on cost analysis). Our previous audit reports of Hamilton Sundstrand have shown that using price analysis of previous noncompetitive prices results in prices that are 77.7 to 280 percent higher than fair and reasonable as determined by cost analysis.
- enter into or proceed with a strategic supplier initiative with a contractor that refuses to provide DoD contracting officers cost information when requested. Hamilton Sundstrand has taken the position that it will not provide DoD and Air Force officials with cost information when requested. The contractor needs to provide the cost information for the 24 Phase 1 items requested by the Air Force and the data need to be reviewed by appropriate DoD audit agencies. Until this is done, the Phases 2 and 3 of the strategic supplier initiative should not proceed. If Hamilton Sundstrand continues to refuse to provide the cost information, the Air Force needs to take aggressive action to develop new sources for high demand items and consider giving the contractor an unsatisfactory performance rating.

See the Finding section of the report for a discussion of management comments on the recommendations and our audit response. See the Management Comments section of the report for the complete text of comments.

# **Table of Contents**

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<b>Executive Summary</b>	i
<b>Background</b>	1
<b>Objectives</b>	4
<b>Findings</b>	
A. Commercial Item Exception to Cost or Pricing Data	5
B. “Commercial” Pricing Strategy for Noncompetitive Spare Parts	29
<b>Appendixes</b>	
A. Scope and Methodology	67
B. Prior Coverage	71
C. Pricing Issues for Generators and Generator Components	73
D. Report Distribution	81
<b>Management Comments</b>	
Under Secretary of Defense for Acquisition, Technology, and Logistics	83
Assistant Secretary of the Air Force (Acquisition)	89
Assistant Secretary of the Air Force (Acquisition) Technical Corrections	96

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## Background

**Acquisition Reform Legislation.** Congress commissioned an Advisory Panel on Streamlining and Codifying Acquisition Laws pursuant to Section 800 of the National Defense Authorization Act of Fiscal Year 1991. In January 1992, the panel completed its report and recommended a comprehensive overhaul of Federal procurement laws to:

Improve Government access to commercial technologies;

Reduce administrative overhead, especially in light of anticipated reductions in the federal acquisition workforce, and

Reverse a perceived trend toward the incremental enactment of procurement statutes without clear analysis of their impact on the overall acquisition system [Senate Report 103-258, May 11, 1994].

On October 13, 1994, Congress enacted Public Law 103-355, the "Federal Acquisition Streamlining Act of 1994," (FASA). FASA amended section 2306a, title 10, United States Code (10 U.S.C. 2306a), "Cost or pricing data: truth in negotiations," to establish an exception from the submission of cost or pricing data for established catalog or market prices of commercial items that are sold in "substantial quantities to the general public." FASA specifically addressed noncompetitive commercial items and required information on prices at which the same or similar items "have been sold in the commercial market that is adequate for evaluating, through price analysis, the reasonableness of price," before a contracting officer could grant an exception to cost or pricing data.

The new exception shall be used where competition is not practicable and the contracting officer obtains appropriate data on prices charged for the same or similar products in the commercial marketplace under standards and procedures set forth in the Federal Acquisition Regulation that the contracting officer determines is adequate to determine price reasonableness [Senate Report 103-258, May 11, 1994].

The overall thinking behind FASA was that:

This approach would relieve commercial contractors from what they consider their number one disincentive to participating in government procurement – the burden of collecting cost data for the government.

By easing many of these requirements, the bill may encourage more firms to bid on government contracts, which might lower prices through increased competition. Reducing the information burden also may lower bids from all firms if bidders can dispense with separate accounting systems for federal and commercial contracts [Senate Report 103-258, May 11, 1994].

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On February 10, 1996, Congress enacted Public Law 104-106, the "National Defense Authorization Act for Fiscal Year 1996." Division D of the Act was titled the "Federal Acquisition Reform Act of 1996," (FARA). FARA further amended 10 U.S.C. 2306a by removing the requirement for commercial items to be sold in substantial quantities to the general public and eliminating specific guidance for noncompetitive commercial items.

**RAND Corporation Research on "Price-Based Acquisition."** In 2005, RAND Corporation reported its research findings (sponsored by the Air Force) on the use and potential benefits of priced-based acquisition (PBA) for DoD procurement of major military-unique systems. Specifically, the report described PBA as such:

Its core concept is the procurement of goods and services through a commercial-like market pricing approach rather than the traditional heavily regulated, cost-based DoD approach using certified cost or pricing data.

The RAND research addressed many of the anecdotal benefits of commercial price-based acquisition found in FASA and FARA. The RAND findings on several of the key research questions were:

Is there documented evidence that prices paid for DoD systems, goods, and services have been reduced through the use of PBA compared with CBA [cost-based acquisition] processes? The answer to the first question is basically no.

Is there documented or anecdotal evidence that PBA has reduced contractor overhead rates/charges? The answer here is also no, for many reasons.

Is there evidence that additional competitors (at the prime, subcontractor, or supplier levels), particularly companies that do not normally do business with DoD, have participated in DoD procurements as a result of PBA? The answer here is that we found little evidence that PBA had any significant impact on bringing in new suppliers and/or technologies to DoD weapon system programs.

**Commercial Pricing Issues.** During the last 9 years, the DoD Office of Inspector General (OIG) has worked closely with the Defense Logistics Agency (DLA) and other DoD Components to achieve fair and reasonable pricing for noncompetitive items. We have issued a series of reports involving the pricing of both commercial and noncommercial noncompetitive spare parts (see Appendix B for a list of prior audit reports).

Both the OIG and the Government Accountability Office (GAO) continue to identify risks in implementing commercial practices for contract pricing. In its January 2001 report, "Performance and Accountability Series: Major Management Challenges and Program Risks, Department of Defense," GAO identified implementing commercial practices for contract pricing as a "high-risk area" under contract management and stated:

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### Adjusting to Commercial Contract Pricing Practices

In recent years, DoD has significantly changed the way it acquires goods and services by removing what were considered barriers to efficient and effective use of the commercial marketplace. A major focus of these changes is the adoption of commercial buying practices. For example, for an increasing number of contracts for sole-source spare parts, DoD is transitioning from a cost-based pricing environment, in which contractor costs are the basis to negotiate prices, to a market-based or commercial pricing environment in which factors other than cost, such as pricing data, are the principal means used to determine the reasonableness of prices. While the level of commercial contracting remains relatively small compared to total DoD procurement, it is likely to increase substantially in the coming years.

Both we and the DoD Inspector General have found and recommended that DoD needs to strengthen its efforts to obtain fair and reasonable prices. For example, the Inspector General found that DoD needs to use more cost-effective buying strategies for commercial spare parts. The Inspector General noted that DoD was paying higher prices for some commercial spare parts than necessary. Our work also identified cases in which limited price analyses of commercially offered prices resulted in significantly higher prices than previously paid. DoD is taking steps to improve its workforce training in commercial buying and pricing. How well DoD's acquisition workforce will adjust to an environment with increased use of commercial pricing practices remains to be seen.

**Previous Hamilton Sundstrand Audits.** DoD Inspector General Report No. 98-064, "Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111," February 6, 1998, showed that DLA paid about \$4.5 million (280 percent) more than fair and reasonable prices for \$6.1 million of "commercial items" purchased from Sundstrand during calendar years 1994 through 1996. The audit showed that higher prices were paid for commercial items because:

- as a sole-source supplier with technical data rights, Sundstrand set "market-based" catalog prices for commercial items at "what the market would bear," and there was no competitive commercial market to ensure the reasonableness of prices;
- Sundstrand refused to negotiate catalog prices for commercial items based on price analysis of previous cost-based prices, refused to provide DLA contracting officers with "uncertified" cost or pricing data for commercial catalog items, and terminated Government access to the Sundstrand cost history system; and
- guidance on commercial items qualified any item "offered for sale, lease, or license to the general public" as a commercial item without clearly addressing commercial pricing concerns, particularly when DoD was the primary customer procuring significantly larger quantities than other commercial customers.

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In June 1999, United Technologies Corporation acquired Sundstrand and merged it with its Hamilton Standard division forming Hamilton Sundstrand Corporation.

DoD Inspector General Report No. D-2004-012, "Sole-Source Spare Parts Procured From an Exclusive Distributor," October 16, 2003, showed that DLA paid prices that were \$7.4 million (77.7 percent) higher than fair and reasonable prices on 35 orders (29 contracts) for 11 sole-source Hamilton Sundstrand spare parts procured from AAR Defense Systems from March 1999 through August 2002. The prices paid to AAR Defense Systems, an exclusive distributor for Hamilton Sundstrand, were too high because contracting officers:

- were directed by the original equipment manufacturer (OEM), Hamilton Sundstrand, to procure spare parts through its exclusive distributor even though the distributor provided limited value to DoD;
- relied on inaccurate and misleading information other than cost or pricing data originating from Hamilton Sundstrand and failed to perform cost analysis of OEM prices to determine price reasonableness; and
- failed to sufficiently document and escalate negotiations in cases where the behavior of the OEM was either unreasonable or uncooperative.

## Objectives

Our overall audit objectives were to review the basis for DLA transferring contracting responsibility for Hamilton Sundstrand consumable items on the strategic sourcing contract to the Air Force, evaluate the adequacy of commercial item determinations, assess the basis for determining fair and reasonable prices, and determine the impact that a commercial procurement strategy has on the prices of sole-source spare parts. See Appendix A for a discussion of the scope and methodology. See Appendix B for prior coverage related to the objectives.

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## A. Commercial Item Exception to Cost or Pricing Data

The Air Force negotiating team used questionable commercial item determinations that exempted Hamilton Sundstrand from the requirement to submit cost or pricing data (Truth in Negotiations Act [10 U.S.C 2306a]) on an \$860 million commercial contract for noncompetitive spare parts used on Defense weapon systems. The Air Force also did not establish an effective means to determine price reasonableness of the exempt “commercial” items. This occurred because:

- guidance on *commercial item determinations and commercial item exceptions to cost or pricing data* in the United States Code, Federal Acquisition Regulation, and other DoD guidance has become muddled and disordered; and
- DoD has not revised and clarified the procedures and methods to be used for *determining the reasonableness of prices of exempt commercial items* in the Federal Acquisition Regulation as required by the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999.

As a result, the negotiating team classified basically all Hamilton Sundstrand noncompetitive spare parts as exempt commercial items and relied primarily on price analysis of previous Government prices that had been determined not to be fair and reasonable by DLA and on previous audits (see finding B). This strategy places the Government at high risk of paying excessive prices and profits and precludes good fiduciary responsibility for DoD funds.

## Background

**Truth in Negotiations Act.** Congress has historically expressed concern with the use of other-than-competitive contracts that typically were negotiated between the parties. Noncompetitive contracts increase the risk that the Government will pay unreasonable prices and that the contractors will earn excessive profits. Based on these concerns, Congress passed the Truth in Negotiations Act (TINA) on September 10, 1962, that required contractors to submit cost or pricing data before the award of a negotiated contract and to certify that the data are accurate, complete, and current. The purpose of TINA was to provide the Government with all the facts on cost and pricing that the contractor used to prepare the proposal so that the Government could negotiate far more knowledgeably and avoid paying excessive prices and profits. Throughout the years, amendments have modified TINA requirements; the current statutory authority is in 10 U.S.C. 2306a.

In response to a contractor report, “The DoD Regulatory Cost Premium: A Quantitative Assessment,” prepared for the Secretary of Defense in

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December 1994, the Director, Defense Procurement commented (June 1995) on the benefits of TINA, marketplace pricing, and the differences between DoD and commercial procurement environment.

The requirements of TINA are necessary to ensure the integrity of DoD spending for military goods and services that are not subject to marketplace pricing. When there is a market that establishes prices by the forces of supply and demand, the market provides the oversight. DoD procures many highly complex military systems in the absence of supply/demand situations for these relatively low volume, unique military goods. The requirements of TINA address legitimate and necessary differences between DoD and commercial procurement environments.

While DoD recognizes the need for TINA, it also is moving to increase competition and decrease the number of pricing actions that would require cost or pricing data. The implementation of FASA, with its emphasis on encouraging the acquisition of commercial end items and increased competition, will bring the requisite market forces to bear on prices, and thus exempt contractors from the requirement to submit cost or pricing data. Absent this competition, the quantitative benefit to the Government of TINA compliance far exceeds the cost of Government oversight. These benefits are best illustrated by the fact that during FY 94, oversight work related to TINA resulted in net savings of \$2 billion on DoD contracts. When compared to the cost of \$761 million for TINA compliance the benefits represent a 267% return on investment.

**Commercial Item Definition.** The commercial item definition, as amended by FARA, requires that commercial items need only be offered for sale and need not be sold competitively or in substantial quantities. The definition also allows commercial "of a type" or similar items to qualify military-unique items with no commercial sales as commercial items. Consequently, any noncompetitive item DoD purchases can arguably be classified as a commercial item. The guidance does establish a significant difference between determinations for commercial items and commercial services. The key difference for services is that they must be sold competitively and in substantial quantities unless the services support an item that was determined to be commercial. The broadness of the commercial item definition is addressed in DoD Inspector General Report No. D-2006-116, "Commercial Contracting for the Acquisition of Defense Systems," September 29, 2006. Commercial items and services are defined in 41 U.S.C. 403, "Definitions."

(12) The term "commercial item" means any of the following:

(A) Any item, other than real property, that is of a type customarily used by the general public or by nongovernmental entities for purposes other than governmental purposes, and that--

(i) has been sold, leased, or licensed to the general public; or

(ii) has been offered for sale, lease, or license to the general public.

(B) Any item that evolved from an item described in subparagraph (A) through advances in technology or performance and that is not yet

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available in the commercial marketplace, but will be available in the commercial marketplace in time to satisfy the delivery requirements under a Federal Government solicitation.

(C) Any item that, but for --

(i) modifications of a type customarily available in the commercial marketplace, or

(ii) minor modifications made to meet Federal Government requirements, would satisfy the criteria in subparagraph (A) or (B).

(D) Any combination of items meeting the requirements of subparagraph (A), (B), (C), or (E) that are of a type customarily combined and sold in combination to the general public.

(E) Installation services, maintenance services, repair services, training services, and other services if --

(i) the services are procured for support of an item referred to in subparagraph (A), (B), (C), or (D), regardless of whether such services are provided by the same source or at the same time as the item; and

(ii) the source of the services provides similar services contemporaneously to the general public under terms and conditions similar to those offered to the Federal Government.

(F) **Services offered and sold competitively, in substantial quantities, in the commercial marketplace** based on established catalog or market prices for specific tasks performed and under standard commercial terms and conditions. [emphasis added]

**“Of a Type” Guidance.** On January 5, 2001, as a result of inconsistent commercial item determinations, weak market research, and confusion concerning pricing of commercial items, the Under Secretary of Defense for Acquisition and Technology (now Acquisition, Technology, and Logistics) [USD(AT&L)] issued guidance clarifying the criteria necessary for contracting officers to make more consistent commercial item determinations. Specifically, the guidance established that the intent of the commercial item definition “of a type” was not to use a commercial acquisition strategy to acquire noncompetitive military-unique parts that are not similar to items already available in the commercial marketplace. Instead, the term “of a type” broadens the statutory commercial item definition to allow Federal Acquisition Regulation (FAR) Part 12 acquisition of a *“government-unique item that can compete with commercial items that meet the government’s requirement.”*

The phrase “of a type” is not intended to allow the use of FAR Part 12 to acquire sole-source, military-unique items that are not closely related to items already in the marketplace. Instead, “of a type” broadens the commercial item definition so that qualifying items do not have to be identical to those in the commercial marketplace. The best value offer in a competitive Part 12 solicitation can be an item that has previously satisfied the Government’s needs but has not been sold, leased, licensed, nor offered for sale, lease or license to the general public. In this scenario, the phrase “of a type” allows the best value offer to qualify for a Part 12 contract as long as it is sufficiently like similar items that meet the government’s requirement and are sold, leased, licensed, or offered for sale, lease or license to the general public. In such instances, “of a type” broadens the statutory commercial item definition to allow Part 12 acquisition of a

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government-unique item that can compete with commercial items that meet the government's requirement. This avoids the undesirable result of shutting out otherwise price-competitive preexisting suppliers of government-unique items from Part 12 solicitations. [emphasis added]

## Commercial Item Determinations

Air Force and DLA contracting officers (negotiating team) made questionable and conflicting commercial item determinations that *basically classified all spare parts supplied by Hamilton Sundstrand under the strategic sourcing contract as commercial items*. Specifically, the commercial item determinations did not evaluate whether there was a commercial market to establish reasonable prices by the forces of supply and demand and did not meet the "of a type" intent for commercial items as previously clarified by the Under Secretary of Defense for Acquisition and Technology. *In particular, contracting officers did not require the submission of data other than certified cost or pricing data to include appropriate information on prices at which the same item or similar items had previously been sold in the commercial market that is adequate for evaluating the reasonableness of price.* Although this information is required by the United States Code and FAR, the guidance has become muddled and disordered. Instead, the contracting team relied on Hamilton Sundstrand's declaration of commercial items and conflicting Air Force and DLA technical reviews to make commercial item determinations.

**Hamilton Sundstrand Commercial Item Declaration.** On February 24, 2003, Hamilton Sundstrand declared that all of its noncompetitive items were commercial based on categories of end item equipment groups that share common characteristics and manufacturing processes. In a memorandum, Hamilton Sundstrand stated:

All of these items fall into groups of equipment that are "of a type" (shares common traits or characteristics that distinguish the end items/parts as an identifiable group or class; and has the features of the group or class), and "sold" to the "general public." The items are manufactured, assembled, and tested by the same work force, in the same facilities, with the same equipment, and under the same quality system as our commercial products.

**Air Force Commercial Item Determination.** On October 24, 2003, the Air Force contracting officer *determined all items* commercial in the request for proposal F42630-03-R-3351 sent to Hamilton Sundstrand *because the items were "of a type" commonly found in the commercial market, modifications of a type customarily available in the commercial market, or minor modifications of a type not customarily available in the commercial market.*

On February 22, 2005, the Air Force contracting officer issued a similar commercial item determination.

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Based on the review of NSNs [National Stock Numbers] set forth in the letters submitted by Hamilton Sundstrand Corporation, the DLA PCO [Primary Contracting Officer] determinations for the three DLA centers (DSCC [Defense Supply Center Columbus], DSCP [Defense Supply Center Philadelphia], and DSCR [Defense Supply Center Richmond]), and three ALC [Air Logistics Centers] centers (OO-ALC, OC-ALC, and WR-ALC [Ogden, Utah; Oklahoma City, Oklahoma; and Warner Robins, Georgia]), I hereby determine that the Phase I NSNs identified as commercial on the ELIN [Exhibit Line Item Number] Exhibits of contract FA8208-04-D-0002 are commercial items in accordance with the definition of "Commercial" items set forth in FAR 2.101. A large portion of the items are of a type commonly found in the commercial market place in support of commercial aviation requirements. Modifications of some of the items are of a type customarily available in the commercial market place. Modifications of other items are minor modifications of a type not customarily available in the commercial marketplace made to meet Federal Government requirements. The items are manufactured on an integrated production line with little difference between commercial and government items.

**Basis for Air Force Commercial Item Determinations.** The Air Force contracting officer used technical engineers at Ogden Air Logistics Center (ALC) Utah; Oklahoma City ALC, Oklahoma; and Warner Robins ALC, Georgia, to assist with the commercial item determinations. Most of the Ogden ALC items were gear boxes, hydraulic motors, fuel controls, and other components used on the F-16 aircraft, while the Oklahoma City ALC items were generators or generator components used on F-16, KC-135, B-1B, E-3, A-10, and F-5 aircraft. DoD funded approximately \$3.1 billion for research, development, test, and evaluation for the F-16 aircraft. See Appendix C for an overview of aircraft generators. Most of the Warner Robins ALC items were circuit card assemblies for the F-15 aircraft or temperature control equipment for the Low Altitude Navigation and Targeting Infrared for Night (LANTIRN) system. Although the engineers at the three ALCs determined that *the items were initially developed for military application*, they reached conflicting conclusions on whether the items are commercial items.

Based mostly on the engineers' general knowledge of the basic functions of military and commercial end item applications, the Section Chief, Systems Engineering Power Systems Branch, Ogden ALC and the Chief, Engineering Branch Aerospace Accessories Division, Oklahoma City ALC each stated:

We find that although the majority of these items were originally developed for military applications, these items are of a type commonly found in the commercial market place in support of commercial aviation requirements. [emphasis added]

The Chief, F-15 Avionics Engineering Branch and Chief, LANTIRN Engineering Section Combat Systems Development Division, Warner Robins ALC reached a different conclusion and stated:

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We find that these items were developed for military application and are not of a type commonly found in the commercial marketplace in support of commercial aviation requirements. [emphasis added]

In addition, the Ogden and Oklahoma City ALC engineers failed to identify the “of a type” item commonly found in the commercial market or determine whether the “of a type” commercial items were sufficiently similar to the military items and ensure any difference in prices could be identified and justified without resorting to cost analysis when making their recommendations to the contracting officer. As a result, the Air Force *contracting officer had no basis to evaluate information on prices at which the same or similar items had been sold in the commercial market that was adequate for determining price reasonableness through price analysis.*

**DLA Commercial Item Determinations.** Sundstrand (now Hamilton Sundstrand Corporation) declined to submit an offer to a December 1997 Defense Supply Center, Columbus, Ohio (DSCC), noncompetitive solicitation for a corporate contract until the DSCC contracting officer determined that all of the Hamilton Sundstrand items were commercial. Hamilton Sundstrand suggested raising the issue with the Commander, DLA after DSCC challenged the commerciality claims. In a February 18, 1999, memorandum, the contracting officer stated that *the Commander warned the team about making a “religious argument” of the commerciality.* Further, the memorandum cited that *the Commander stated, “it is not politically popular at this juncture to restrict commercial determinations.”* After technical reviews of a sample of the items, the DSCC contracting officer stated:

Given a more liberal rendering, an argument can be made that commerciality has not been disproved by the government’s findings and do obviously have commercial counterparts albeit sometimes remote. Rather than continuing an effort evaluating commerciality that leaves us still without a legitimate offer from Sundstrand it is determined given the low level of risk to determine the entire population commercial. Doing so will allow the contracting officer to move forward in soliciting these items under a commercial solicitation and to focus their attention on the pricing of this material.

The DSCC contracting officer only submitted the above commercial item determination for the Hamilton Sundstrand strategic sourcing contract.

On February 25, 2003, and March 3, 2003, the contracting officers at the Defense Supply Center, Richmond, Virginia (DSCR), and the Defense Supply Center Philadelphia, Pennsylvania (DSCP), in a memorandum stated:

Based on the review of NSNs and the letter submitted by Hamilton Sundstrand, dated February 24, 2003, the contracting officer hereby determines that the NSNs identified as Phase 1, 2, or 3 of the Hamilton Sundstrand Contract Exhibits excel file and any future NSNs that are determined to be sole source to Hamilton Sundstrand meet the definition of commercial item per FAR 2.101(3)(ii), based on the items

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being manufactured on an integrated production line, with little differentiation between the commercial and government items.

On January 28, 2005, the DSCR contracting officer modified the previous DLA commercial item determinations to incorporate past dealings with Hamilton Sundstrand and to include details of a review conducted by an equipment specialist:

As stated in previous letter, February 24, 2003, concerning the Determination of Commerciality for the sole-source NSNs for Hamilton Sundstrand that will be part of Sole Source Initiative (SSI) contract the Air Force is working. The Equipment Specialist has reviewed specific NSNs and groups of items identified and the conclusion is that the majority of the NSNs could be determined commercial based on the definition at FAR 2.101(3)(i)(ii), "Modification of a type customarily available in the commercial marketplace." And "minor modifications of a type not customarily available in the commercial workplace made to meet Federal Government requirements."

Therefore, based on DLA's past dealings with Hamilton Sundstrand of previous corporate contract D9713 and VPV contract 9432) [sic], the contracting officer determines that the NSNs that are part of Phase 1, 2 or 3, and the attachment 2 and any future NSNs that will be added to the Air Force SSI contract are determined to be sole-source to Hamilton Sundstrand and meets the definition of a commercial item per FAR 2.101(3)(i)(ii).

On February 8, 2005, the DSCR contracting officer again modified the DLA commercial item determination to include further details of the review conducted by an equipment specialist. The updated determination found that all DLA parts including parts managed by DSCR, DSCC, and DSCP were commercial as stated:

Per our technical review, the conclusion was that "the items in the sample group are commercial in nature." Per letter from Hamilton, many of the military products were developed from commercial applications and are manufactured without segregation from the commercial application items. The processes, materials, methods of inspection and testing are the same for both. Therefore, the items may be deemed commercial by similarity. Fourteen NSNs of the 200 sampled are listed in the Hamilton Sundstrand Commercial Spare Parts Catalog for 2004. These are determined exact commercial product. This is also based on the definition at FAR 2.101(3)(i)(ii), "Modification of a type customarily available in the commercial marketplace." And "minor modifications of a type not customarily available in the commercial marketplace made to meet Federal Government requirements." Therefore based on DLA's past dealings with Hamilton Sundstrand of previous corporate contract D9713, a Columbus contract which were deemed commercial on 12/19/2002 and the Virtual Prime Vendor contract 9432, 1,134 DLA NSNs, which was deemed commercial, the contracting officer determines that the NSNs that are part of Phase 1, 2, or 3 are determined to be sole source to Hamilton

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Sundstrand and meets the definition of a commercial item per FAR 2.101-(3)(i)(ii).

The DLA primary contracting officer determined that all 959 DLA-managed items awarded in Phase 1 of the strategic sourcing contract and subsequent items added in Phases 2 and 3 were commercial items based on previous corporate contracts with Hamilton Sundstrand and technical reviews of 200 items performed by an equipment specialist and not a qualified engineer due to limited resources.

The DLA commercial item determination was subsequently updated by the Chief of OEM Branch 1, Supplier Operations, DSCR. The updated DLA commercial item determination, which was not dated, limited the group of items determined commercial to Phase 1 items and provided further explanation of the commerciality review:

During the time period January 27 to February 4, 2005, a commercial review from the technical perspective was performed by a team consisting of a Quality Assurance Specialist and a Quality Assurance Team Lead on the Hamilton Sundstrand Integrated Supplier Team. The items reviewed were a sample of 200 items identified as meeting the commercial definition of FAR 2.101(c)(1).

The Government selected a sample of 200 of 1,017 items on Phase 1 of the SSI contract to review. The 200 items selected were those items that are high end items and have high demands for DLA. The 200 represents 20% of the expected annual value of \$3,888,716.23 for the overall population. The review was to determine, 1) how alike the military item was to a commercial item selected as a representative item? 2) Are the items of a type customarily found in the commercial market? 3) Do the items share manufacturing processes? 4) Is the military item linked to commercial items through engineering references and notes on the drawing packages? Hamilton Sundstrand provided us with engineering prints for our review. Additionally they provided us access to members of their engineering staff to address our technical questions as they arose during the reviews.

The Government review was conducted in accordance with DSCR procedure "Interim Guidance for Commercial Determinations" dated April 19, 2002.

Of the 200 NSN's, 14 can be found in the Hamilton Sundstrand Commercial Spare parts Catalog for 2004. These are determined to be the "exact" commercial product.

A majority of the items reviewed, 146 of 200 (73%), demonstrated that the military items were like the commercial items in the majority of common characteristics. The differences found in these items were typically of a type found in the commercial marketplace i.e., size, material and slight configuration. Functions were similar in all instances. Specific to the Generator applications, the type of generators used for a particular military end item were grouped with

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their commercial counter parts. The drawings supplied were for a selection of generators. They were not complete engineering drawings; however, similarity was determined based on their common characteristics. The population of 146 NSNs is determined to be commercial by "similarity" as defined by FAR 2.101(3)(d), items that possess "sufficient common characteristics."

Additionally, 39 of the 200 (20%), are gearbox components. These were determined commercial based upon previous history for commercial determinations, a letter from Lockheed Martin dated August 5, 1999, stating "the Engine Start Systems and related electric power generation equipment supplied by Hamilton Sundstrand for the F-16... are commercial items ..."

Of the items reviewed, 1 out of the 200 was a pump. The information supplied on the Fluid Pumping Equipment states the military applications were developed from the commercial applications and there are no distinctions between the equipment and processes utilized in manufacturing. This certification would meet the determination of "modified" commercial item as defined by FAR 2.101(3)(c)(1); "modification of a type customarily available in the commercial marketplace".

It is our opinion that the items are clearly within the parameters established by the review team and the FAR; therefore should be deemed commercial. The sample population of 200 items should be an adequate representation of commerciality of the Phase One items.

Another undated version of the DLA commercial item determination prepared by the Chief of OEM Branch 1, Supplier Operations, DSCR contained the exact language discussed above except that the last paragraph was replaced with an explanation that without determining these items commercial, Hamilton Sundstrand would not offer to provide these items to DLA. Specifically, the last paragraph stated:

Rather than continuing an effort evaluating commerciality that leaves us still without a legitimate offer from Hamilton Sundstrand it is determined given the low level of risk to determine the entire population commercial. The items are clearly within the parameters established by the review team and should be deemed commercial; therefore, the sample population of 200 items should be an adequate representation of commerciality.

Similar to the Air Force engineers, the DLA equipment specialist failed to identify the "of a type" item commonly found in the commercial market or determine whether the "of a type" commercial items were sufficiently similar to the military items to ensure any difference in prices could be identified and justified without resorting to cost analysis. As a result, *the DLA contracting officer also had no basis to evaluate information on prices at which the same or similar items had been sold in the commercial market that was adequate for evaluating, through price analysis, the reasonableness of the price.* Most of the DLA items are consumable components used on F-16, F-15, F/A-18, KC-135,

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B-1B, and E-3A aircraft. See Appendix C for pictures of components of different aircraft generators.

**Commercial Sales Data for Air Force Contract.** Hamilton Sundstrand provided commercial sales histories of similar items for 10 items with an annual price of about \$4.6 million, which represents 23.6 percent of the annual price for 1,011 items (\$19.6 million). However, the sales data did not provide DLA and the Air Force with sufficient information to establish price reasonableness because the sales quantities for the similar parts were significantly lower than DoD requirements. For example, a shaft assembly [National Stock Number (NSN) 2835-01-208-7789] used on the F-16 aircraft has an annual demand requirement of 421. Hamilton Sundstrand only provided commercial sales of one similar part that totaled six from 2000 through 2004 or slightly more than one annually. Due to the lack of adequate commercial sales, the contracting officer relied on price analysis of the previous Government price to negotiate the contract price for this item.

In addition, the sales data provided by Hamilton Sundstrand was an incomplete picture of the total market for the items because *Hamilton Sundstrand excluded OEM and Hamilton Sundstrand joint venture sales of the similar items*. Based on our review of sales histories of the exact item, we found that OEM sales prices were usually lower than both DoD and commercial customer sales prices. For example, Hamilton Sundstrand sales data showed that in April 2002 Lockheed Martin purchased one starting fuel control for the F-16 aircraft turbine engine (NSN 2910-01-135-5681) for a unit price of \$613.37 and another of the item for \$607.68, while the Air Force purchased two of the item in January 2000 for \$9,344 each or 1,423.4 to 1,437.7 percent more than the OEM price. In February 2003, the Air Force purchased 13 additional fuel controls at a unit price of \$13,614.24 from AAR Defense Systems, Hamilton Sundstrand's exclusive distributor. According to the DSCR cost analyst, Hamilton Sundstrand stated that OEM sales prices were not a valid basis to establish prices because the sales sometimes represent "high-level business decisions" that were used to impact future work instead of the actual cost of the items. For this reason, Hamilton Sundstrand refused to provide any OEM sales data on any subsequent requests of sales histories made by DoD contracting officials. In June 2006, Hamilton Sundstrand provided documents to the Air Force contracting officer that showed the Lockheed Martin sales were repairs and not purchases of a new fuel control. However, the Hamilton Sundstrand sales data did not indicate that these transactions were repairs instead of actual sales. If the Hamilton Sundstrand sales data include repairs with actual sales, we question the reliability and usefulness of the sales information to develop contract prices.

In order to make valid pricing decisions for commercial items, contracting officers must have a complete history of commercial market sales that includes OEM or prime contractor sales and any other sales of the exact or similar items. Contractors must not be allowed to pick and choose the sales history provided to DoD contracting officials because the contractor can influence the price negotiated by providing only high commercial prices and there is no incentive to provide commercial sales that have lower prices. If contracting officials do not obtain commercial sales of similar quantities to DoD annual demand quantities,

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the results of any price analysis will not be effective to establish price reasonableness.

## **Price Reasonableness of Exempt Noncompetitive Commercial Items**

The Air Force and DLA contracting officers did not adequately determine price reasonableness of exempt noncompetitive commercial items because effective procedures and methods had not been developed and incorporated into the FAR as required by the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999. Even though the Air Force requested additional cost information from the contractor to support price reasonableness as required, the contractor refused to provide the cost information. Thus, the Air Force and DLA were forced to rely primarily on price analysis of previous Government prices that had been determined not to be fair and reasonable by DLA and on previous audits (see finding B). This strategy places the Government at high risk of paying excessive prices and profits and precludes good fiduciary responsibility for DoD funds.

## **Guidance on Commercial Item Determinations and Commercial Item Exceptions to Cost or Pricing Data**

Guidance on *commercial item determinations and commercial item exceptions to cost or pricing data* in the United States Code and FAR has become muddled and disordered. Current guidance on the definition of commercial items allows contractors to continuously argue with contracting officers that basically every item DoD purchases is a commercial item. Guidance in FASA required that commercial items be sold in substantial quantities and provided "Additional Special Rules for Commercial Items" addressing differences in commercial item exceptions for competitive and noncompetitive procurements. FASA also provided clear guidance for noncompetitive procurements on obtaining commercial sales information from the offeror or contractor, performing price analysis of the commercial sales to determine price reasonableness, the situations when a commercial item exception applied, and the situations when a contracting officer should request cost or pricing data.

However, FARA amended 10 U.S.C. 2306a by removing the FASA requirement that commercial items be sold in substantial quantities and the specific requirement that items be "sold in the commercial market" for noncompetitive procurements of commercial items. FARA also did not clearly distinguish the limitations on requests for information between competitive and noncompetitive procurements. Excerpts from FARA have subsequently been incorporated into the FAR with unclear guidance relating to exceptions from cost or pricing data for noncompetitive commercial items and the data that should be requested to determine price reasonableness.

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**FASA.** On October 13, 1994, Congress enacted Public Law 103-355, the “Federal Acquisition Streamlining Act of 1994.” The purpose of FASA was to:

... revise and streamline the acquisition laws of the Federal Government in order to reduce paperwork burdens, facilitate the acquisition of commercial products, enhance the use of simplified procedures for small purchases, clarify protest procedures, eliminate unnecessary statutory impediments to efficient and expeditious acquisition, achieve uniformity in the acquisition practices of Federal agencies, and increase the efficiency and effectiveness of the laws governing the manner in which the Government obtains goods and services. [Senate Report 103-258]

Specifically, FASA amended subsection (b) “Exceptions” of 10 U.S.C. 2306a, “Cost or pricing data: truth in negotiations,” to provide an exception for commercial items sold in substantial quantities. Subsection (b) stated:

**(b) EXCEPTIONS.-**

(1) **IN GENERAL.** – Submission of cost or pricing data shall not be required under subsection (a) in the case of a contract, a subcontract, or modification of a contract or subcontract--

(A) for which the price agreed upon is based on--

(i) adequate price competition;

(ii) established catalog or market prices of commercial items that are sold in substantial quantities to the general public; or

(iii) prices set by law or regulation; or

(B) in an exceptional case when the head of the procurement activity, without delegation, determines that the requirements of this section may be waived and justifies in writing the reasons for such determination. [emphasis added]

FASA provided additional exception provisions for commercial items and established a preference for procurement of commercial items on a competitive basis and that agencies should generally not request additional information from the offeror on competitive solicitations. In addition, *FASA provided specific guidance for noncompetitive commercial items requiring that the contracting officer obtain information on prices at which the same or similar items have been sold in the commercial market from the offeror or contractor that is adequate for evaluating, through price analysis, the reasonableness of price.* The contracting officer may also require submission of cost or pricing data if the offeror or contractor failed to provide such information. FASA amended 10 U.S.C. 2306a as follows:

**(d) ADDITIONAL EXCEPTION PROVISIONS REGARDING COMMERCIAL ITEMS--**

(1) **PROCUREMENTS BASED ON ADEQUATE PRICE COMPETITION.**—To the maximum extent practicable, the head of an agency shall conduct procurements of commercial items on a competitive basis. In any procurement of a commercial item conducted on a competitive basis and based upon adequate price competition, the head of the agency conducting the procurement shall

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not require cost or pricing data to be submitted under subsection (a) for the contract, subcontract, or modification of the contract or subcontract under the procurement. **If additional information is necessary to determine the reasonableness of the price of the contract, subcontract, or modification, the head of the agency shall, to the maximum extent practicable, obtain the additional information from sources other than the offeror.**

**(2) PROCUREMENTS NOT BASED ON ADEQUATE PRICE COMPETITION.**-(A)(i) In any case in which it is not practicable to conduct a procurement of a commercial item covered by subsection (a) on a competitive basis, and the procurement is not covered by an exception in subsection (b), **the contracting officer shall seek to obtain from the offeror or contractor information described in clause (ii).** When such information is not available from that source, the contracting officer shall seek to obtain such information from another source or sources.

(ii) The information referred in clause (i) is **information on prices at which the same item or similar items have been sold in the commercial market that is adequate for evaluating, through price analysis, the reasonableness of the price of the contract, subcontract, or modification of the contract or subcontract under the procurement.**

(B) The contracting officer shall exempt a contract or subcontract, or modification of a contract or subcontract under the procurement from the requirements of subsection (a) if the contracting officer obtains the information described in subparagraph (A)(ii) in accordance with standards and procedures set forth in the Federal Acquisition Regulation.

(C) A contracting officer may require submission of cost or pricing data under subsection (a) only if the contracting officer makes a written determination that the agency is unable to obtain the information described in subparagraph (A)(ii). [emphasis added]

**FARA.** On February 10, 1996, Congress enacted Public Law 104-106, the "National Defense Authorization Act for Fiscal Year 1996." Division D of the Act was titled the "Federal Acquisition Reform Act of 1996." *Section 4201, "Commercial Item Exception to Requirements for Certified Cost or Pricing Data"* amended FASA and eliminated the requirement for commercial items to be sold in substantial quantities to the general public.

FARA also removed the "Additional Exception Provisions Regarding Commercial Items," which included the clear guidance on noncompetitive commercial items. FARA did leave in the requirement for noncompetitive procurements that *requires contracting officers to require the submission of appropriate information on the prices at which the same item or similar items have previously been sold that is adequate for evaluating the reasonableness of price of the procurement.* While the guidance no longer specifically states "sold in the commercial market," it would be impractical to require the submission of information other than sales in the commercial market.

FARA amended 10 U.S.C. 2306a as follows:

SEC. 4201. COMMERCIAL ITEM EXCEPTION TO  
REQUIREMENT FOR CERTIFIED COST OR PRICING DATA

(b) EXCEPTIONS.-

(1) IN GENERAL. — Submission of certified cost or pricing data shall not be required under subsection (a) in the case of a contract, a subcontract, or modification of a contract or subcontract--

(A) for which the price agreed upon is based on--

- (i) adequate price competition; or
- (ii) prices set by law or regulation

(B) for the acquisition of a commercial item; or

(C) in an exceptional case when the head of the procuring activity, without delegation, determines that the requirements of this section may be waived and justifies in writing the reasons for such determination. [emphasis added]

(d) SUBMISSION OF OTHER INFORMATION.-

(1) AUTHORITY TO REQUIRE SUBMISSION.-When certified cost or pricing data are not required to be submitted under this section for a contract, subcontract, or modification of a contract or subcontract, the contracting officer shall require submission of data other than certified cost or pricing data to the extent necessary to determine the reasonableness of the price of the contract, subcontract, or modification of the contract or subcontract. Except in the case of a contract or subcontract covered by exceptions in subsection (b)(1)(A), the data submitted shall include, at a minimum, appropriate information on the prices at which the same item or similar items have previously been sold that is adequate for evaluating the reasonableness of the price of the procurement.

(2) LIMITATIONS ON AUTHORITY.-The Federal Acquisition Regulation shall include the following provisions regarding the types of information that contracting officers may require under paragraph (1):

(A) Reasonable limitations on requests for sales data relating to commercial items.

(B) A requirement that a contracting officer limit to the maximum extent practicable, the scope of any request for information relating to commercial items from an offeror to only that information that is in the form regularly maintained by the offeror in commercial operations.

(C) A statement that any information received relating to commercial items that is exempt from disclosure under section 552(b) of title 5 shall not be disclosed by the Federal Government.

**Deleted:** established catalog or market prices of commercial items that are sold in substantial quantities to the general public;

**Deleted:** ADDITIONAL EXCEPTION PROVISIONS REGARDING COMMERCIAL ITEMS.-

**Deleted:** PROCUREMENTS BASED ON ADEQUATE PRICE COMPETITION.-To the maximum extent practicable, the head of an agency shall conduct procurements of commercial items on a competitive basis. In any procurement of a commercial item conducted on a competitive basis and based upon adequate price competition, the head of the agency conducting the procurement shall not require cost or pricing data to be submitted under subsection (a) for the contract, subcontract, or modification of the contract or subcontract under the procurement. If additional information is necessary to determine the reasonableness of the price of the contract, subcontract, or modification, the head of the agency shall, to the maximum extent practicable, obtain the additional information from sources other than the offeror.

**Deleted:** PROCUREMENTS NOT BASED ON ADEQUATE PRICE COMPETITION.-

**Deleted:** (i) In any case in which it is not practicable to conduct a procurement of a commercial item covered by subsection (a) on a competitive basis, and the procurement is not covered by an exception in subsection (b), the contracting officer shall seek to obtain from the offeror or contractor information described in clause (ii). When such information is not available from that source, the contracting officer shall seek to obtain such information from another source or sources.

(ii) The information referred in clause (i) is information on prices at which the same item or similar items have been sold in the commercial market that is adequate for evaluating through price analysis, the reasonableness of the price of the contract, subcontract, or modification of the contract or subcontract under the procurement.

**Deleted:** The contracting officer shall exempt a contract or subcontract, or modification of a contract or subcontract under the procurement from the requirements of subsection (a) if the contracting officer obtains the information described in subparagraph (A)(ii) in accordance with standards and procedures set forth in the Federal Acquisition Regulation.

**Deleted:** A contracting officer may require submission of cost or pricing data under subsection (a) only if the contracting officer makes a written determination that the agency is unable to obtain the information described in subparagraph (A)(ii).

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When (d)(1) "Authority to Require Submission," was incorporated in Section 2306a, there was no mention that it specifically relates to noncompetitive commercial items. FARA also placed additional limitations on information that contracting officers should request *but did not clearly distinguish between competitive and noncompetitive procurements*. FASA, however, made it clear that the head of the agency should to the maximum extent practicable, obtain additional information from sources other than the offeror for *competitive commercial item procurements and that the contracting officer shall obtain information from the offeror or contractor for noncompetitive commercial item procurements*.

**FAR Pricing Guidance on Commercial Items Exceptions to Cost or Pricing Data Requirements.** FAR 15.403-1, "Prohibition on Obtaining Cost or Pricing Data" (10 U.S.C. 2306a and 41 U.S.C. 254b), provides guidance on commercial items exceptions to cost or pricing data requirements. It also addresses guidance in the Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005 that prohibits the commercial item exception to cost or pricing for noncommercial modifications of commercial items, if the cost of the modification exceeds the greater of \$500,000 or five percent of the total contract price. The exception for a commercial item states:

(b) Exceptions to cost or pricing data requirements....

(3) When a commercial item is being acquired (see standards in paragraph (c)(3) of this subsection);

(c) Standards for exceptions from cost or pricing data requirements--

...

(3) Commercial items.

(i) Any acquisition of an item that meets the commercial item definition in 2.101, or any modification, as defined in paragraph (3)(i) of that definition, that does not change the item from a commercial item to a noncommercial item, is exempt from the requirement for cost or pricing data. If the contracting officer determines that an item claimed to be commercial is, in fact, not commercial and that no other exception or waiver applies, the contracting officer must require submission of cost or pricing data.

(ii) The following requirements apply to minor modifications defined in paragraph (3) (ii) of the definition of a commercial item at 2.101 that do not change the item from a commercial item to a noncommercial item:

(A) For acquisitions funded by any agency other than DoD, NASA, or Coast Guard, the modifications are exempt from the requirement for submission of cost or pricing data.

(B) For acquisitions funded by DoD, NASA, or Coast Guard, the modification are exempt from the requirement for submission of cost or pricing data provided the total cost of the modifications do not exceed the greater of \$500,000 or 5 percent of the total price of the contract.

(C) For acquisitions funded by DoD, NASA, or Coast Guard where the total cost of the modifications exceed

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the greater of \$500,000 or 5 percent of the total price of the contract and no other exception or waiver applies, the contracting officer must require submission of cost or pricing data.

*Because the changes made to the United States Code by FARA did not clearly distinguish requirements for competitive and noncompetitive requirements of commercial items, FAR and DoD guidance has become equally confusing. For example, FAR 15.403-3, "Requiring Information Other Than Cost or Pricing Data,"<sup>1</sup> provides guidance that contracting officers obtain information that is adequate for evaluating the reasonableness of price and generally directs the contracting officer to obtain information from sources other than the offeror. In section "(a) General," the contracting officer is required to request information from the offeror; however, there is no indication in the reference that this applies specifically to noncompetitive commercial items. Section "(c) Commercial items," requires the contracting officer to use price analysis to determine whether the price is fair and reasonable and then places additional limitations on contracting officers relating to commercial items.*

(a) General.

(1) The contracting officer is responsible for obtaining information that is adequate for evaluating the reasonableness of the price or determining cost realism, but the contracting officer should not obtain more information than is necessary (see 15.402 (a)). If the contracting officer cannot obtain adequate information from sources other than the offeror, the contracting officer must require submission of information other than cost or pricing data from the offeror that is adequate to determine a fair and reasonable price 10 U.S.C. 2306a(d)(1) and 41 U.S.C. 254b(d)(1)). Unless an exception under 15.403-1(b)(1) or (2) applies, the contracting officer must require that the information submitted by the offeror include at a minimum, appropriate information on the prices at which the same or similar items have previously been sold, adequate for determining the reasonableness of the price. To determine the information an offeror should be required to submit, the contracting officer should consider the guidance in Section 3.3, Chapter 3, Volume I, or the Contract Pricing Reference Guide cited at 15.404-1(a)(7).

(c) Commercial items.

(1) **At a minimum, the contracting officer must use price analysis to determine whether the price is fair and reasonable whenever the contracting officer acquires a commercial item (see 15.404-1(b)).** The fact that is [sic] price is included in a catalog does not in and of itself, make it fair and reasonable. If the contracting officer cannot determine whether an offered price is fair and reasonable, even after obtaining additional information from sources other than the

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<sup>1</sup> "Information other than cost or pricing data" means any type of information that is not required to be certified in accordance with FAR 15.406-2 and is necessary to determine price reasonableness or cost realism. For example, such information may include pricing, sales, or cost information, and includes cost or pricing data for which certification is determined inapplicable after submission.

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offeror, then the contracting officer must require the offeror to submit information other than cost or pricing data to support further analysis (see 15.404-1).

(2) Limitations relating to commercial items (10 U.S.C. 2306a(d)(2) and 41 U.S.C. 254b(d)).

(i) The contracting officer must limit requests for sales data relating to commercial items to data for the same or similar items during a relevant time period.

(ii) The contracting officer must, to the maximum extent practicable, limit the scope of the request for information relating to commercial items to include only information that is in the form regularly maintained by the offeror as part of its commercial operations.

(iii) The Government must not disclose outside the Government information obtained relating to commercial items that is exempt from disclosure under 24.202(a) or the Freedom of Information Act (5 U.S.C. 552(b)). [emphasis added]

**Optional FAR Contract Clause for Exempt Commercial Items.** There is an optional contract clause at FAR 52.215-20, "Requirements for Cost or Pricing Data or Information Other Than Cost or Pricing Data," that does incorporate FASA guidance for exempt commercial items. The guidance requires that "the offeror shall submit, at a minimum, information on prices at which the same or similar items have previously been sold *in the commercial market* that is adequate for evaluating the reasonableness of the price." However, the clause was not used in the Hamilton Sundstrand strategic sourcing commercial contract.

(a) Exceptions from cost or pricing data.

(1) In lieu of submitting cost or pricing data, offerors may submit a written request for exception by submitting the information described in the following subparagraphs. The Contracting Officer may require additional supporting information, but only to the extent necessary to determine whether an exception should be granted, and whether the price is fair and reasonable.

(ii) *Commercial item exception.* For a commercial item exception, the offeror shall submit, at a minimum, information on prices at which the same item or similar items have previously been sold in the commercial market that is adequate for evaluating the reasonableness of the price for this acquisition. Such information may include —

(A) For catalog items, a copy of or identification of the catalog and its date, or the appropriate pages for the offered items, or a statement that the catalog is on file in the buying office to which the proposal is being submitted. Provide a copy or describe current discount policies and price lists (published or unpublished), *e.g.*, wholesale, original equipment manufacturer, or reseller. Also explain the basis of

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each offered price and its relationship to the established catalog price, including how the proposed price relates to the price of recent sales in quantities similar to the proposed quantities;

(B) For market-priced items, the source and date or period of the market quotation or other basis for market price, the base amount, and applicable discounts. In addition, describe the nature of the market;

(C) For items included on an active Federal Supply Service Multiple Award Schedule contract, proof that an exception has been granted for the schedule item. [emphasis added]

**Defense Procurement Guidance.** On August 2, 2000, the Director, Defense Procurement issued a memorandum, "Obtaining Information for Pricing Sole-Source Commercial Items."

Please remind your contracting professionals that the clause at FAR 52.215-20 should be included in solicitations for sole-source commercial items when the contracting officer has a reasonable expectation that the offeror will request a commercial item exception to a requirement for submission of certified cost or pricing data, and that the offeror will need to provide, at a minimum, appropriate information on the prices at which the same or similar items have been previously sold. Additional information may be requested to the extent needed to permit an adequate evaluation of the proposed price in accordance with FAR 15.403-3. [emphasis added]

However, the Director's guidance again seems confusing. For example, the guidance reminds contracting officers to use FAR 52.215-20 when the contracting officer has a reasonable expectation that the offeror would request a commercial item exception to cost or pricing data. At the same time, it reminds contracting officers not to request information from the contractor or offeror if sufficient information was available within the Government or from other sources.

However, as a matter of policy, FAR 15.402(a) (2)(i) states that offerors should not be requested to provide additional information if the contracting officer already has information, available from within the Government or from other sources, that is adequate for evaluating price reasonableness. [emphasis added]

The guidance on not requesting additional information from the offeror would be appropriate for competitive items but clearly does not apply to noncompetitive items where contracting officers are required to obtain information from the offeror.

**Commercial Item Definition and Commercial Item Exception to Cost or Pricing Data Summary.** The commercial item determinations performed by the Air Force and DLA for items developed primarily for military applications are of little, if any, value because the broadness of the commercial item definition allows virtually any noncompetitive item DoD purchases to be arguably a commercial item and qualify for a commercial item exception to cost or pricing

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data. The broadness of these commercial item determinations and absence of a commercial market raise serious questions as to the extent to which legislative goals and objectives are being achieved for these noncompetitive “commercial items.”

Further, clarifying guidance on “of a type” items provided by the USD(AT&L) has not deterred the use of commercial contracts to acquire noncompetitive military-unique items. Specifically, there is no requirement that a commercial market even exists before an item is determined to be commercial. Marketplace pricing for noncompetitive items that links commercial sales of the same or similar item to sales of military-unique items is critical to determine fair and reasonable prices.

Current guidance in the United States Code, FAR, and other DoD guidance is also confusing because it does not clearly differentiate requirements associated with competitive and noncompetitive procurements of commercial items.

The USD(AT&L) needs to develop and issue guidance for inclusion in acquisition regulations (Defense Federal Acquisition Regulation/FAR) to further clarify exceptions to cost or pricing data for noncompetitive commercial items that:

- Addresses statutory requirements and provides instructions that contracting officers shall require submission of data other than certified cost or pricing data from the offeror or contractor. At a minimum, this data shall include appropriate information on the prices at which the same or similar items have previously been sold in the commercial market that is adequate for evaluating the reasonableness of the price of the procurement.
- Establishes FAR 52-215.20 (ii), “Commercial Item Exception,” as a mandatory contract requirement in FAR Part 12 contracts.
- Instructs contracting officers to limit requests for information from the offeror or contractor on commercial sales to quantities similar to DoD annual demand quantities.
- Instructs appropriate Government officials to make a determination that any “of a type” item is sufficiently similar to the military item and any difference in price can be identified and justified. Any significant difference in similarity or price should be supported by cost analysis.
- Instructs contracting officers to make a determination as to whether commercial sales information provided by the offeror or contractor is adequate to support a price reasonableness determination.
- Instructs contracting officers to require additional “information other than cost or pricing data” from the offeror or contractor that includes cost information when the contracting officer makes a determination that commercial sales information is not adequate to support price reasonableness.

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## Guidance on Determining Price Reasonableness of Exempt Commercial Items

DoD has not revised and clarified the procedures and methods to be used for determining the reasonableness of prices of exempt commercial items in the FAR as required by the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999.

**Strom Thurmond Act.** The Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 requires DoD to revise and clarify in the FAR the procedures and methods to be used for determining the reasonableness of prices of exempt commercial items. Specifically, Section 803, "Defense Commercial Pricing Management Improvement," states:

(a) MODIFICATION OF PRICING REGULATIONS FOR CERTAIN COMMERCIAL ITEMS EXEMPT FROM COST OR PRICING DATA CERTIFICATION REQUIREMENTS—(1) The Federal Acquisition Regulation issued in accordance with sections 6 and 25 of the Office of Federal Procurement Policy Act (41 U.S.C. 405, 421) **shall be revised to clarify the procedures and methods to be used for determining the reasonableness of prices of exempt commercial items** (as defined in subsection (d)).

(2) The regulations shall, at a minimum, provide specific guidance on—

(A) the appropriate application and precedence of such price analysis tools as catalog-based pricing, market-based pricing, historical pricing, parametric pricing, and value analysis;

(B) the circumstances under which contracting officers should require offerors of exempt commercial items to provide--

(i) information on prices at which the offeror has previously sold the same or similar items; or

(ii) other information other than certified cost or pricing data;

(C) the role and responsibility of Department of Defense support organizations in procedures for determining price reasonableness; and

(D) the meaning and appropriate application of the term "purposes other than governmental purposes" in section 4(12) of the Office of Federal Procurement Policy Act (41 U.S.C. 403(12)). [emphasis added]

FAR 15.402, "Pricing Policy," provides an order of preference in determining the type of information required by contracting officers to determine price reasonableness; however, the guidance does not specifically address noncompetitive commercial items. Further, the guidance directs contracting officers away from requesting information from the offeror or contractor that is required by the United States Code for noncompetitive commercial item procurements. The guidance lists *the three least preferable methods of determining fair and reasonable prices for noncompetitive commercial items*:

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*obtaining information from the offeror, obtaining cost information, and obtaining cost or pricing data. Further, while the guidance in (A)(2)(i) is appropriate for competitive procurements, the guidance is not appropriate for noncompetitive procurements.*

Contracting officers must --

(a) Purchase supplies and services from responsible sources at fair and reasonable prices. In establishing the reasonableness of the offered prices, the contracting officer must not obtain more information than is necessary. To the extent that cost or pricing data are not required by 15.403-4, the contracting officer must generally use the following order of preference in determining the type of information required:

(1) No additional information from the offeror, if the price is based on adequate price competition, except as provided by 15.403-3(b).

(2) Information other than cost or pricing data:

(i) Information related to prices (e.g., established catalog or market prices or previous contract prices), relying **first** on information available within the Government; **second**, on information obtained from sources other than the offeror; **and, if necessary, on information obtained from the offeror.** When obtaining information from the offeror is necessary, unless an exception under 15.403-1(b) (1) or (2) applies, such information submitted by the offeror shall include, at a minimum, appropriate information on the prices at which the same or similar items have been sold previously, adequate for evaluating the reasonableness of the price.

(ii) **Cost information, that does not meet the definition of cost or pricing data at 2.101.**

(3) ***Cost or pricing data.* The contracting officer should use every means available to ascertain whether a fair and reasonable price can be determined before requesting cost or pricing data.**

Contracting officers must not require unnecessarily the submission of cost or pricing data, because it leads to increased proposal preparation costs, generally extends acquisition lead-time, and consumes additional contractor and Government resources. [emphasis added]

**Commercial Pricing Summary.** The USD(AT&L) needs to develop and issue guidance for inclusion in acquisition regulations (Defense Federal Acquisition Regulation/FAR) as required by the Strom Thurmond National Defense Authorization Act for FY 1999 to further clarify pricing noncompetitive commercial items to:

- instruct contracting officers to perform price analysis of commercial sales, when sales of the same or similar item previously sold in the

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commercial market are adequate for evaluating, through price analysis, the reasonableness of price and ensure the integrity of commercial sales information.

- instruct contracting officers to obtain “information other than cost or pricing data” which includes cost information and perform cost analysis if commercial sales are not adequate to determine price reasonableness. Price analysis of the previous Government price is acceptable if recent cost analysis or competition was used to support the price and there have been no known changes in the manufacturing process that could significantly impact the contractor’s costs.

**Past Performance.** FAR Subpart 42.15, “Contractor Performance Information,” provides policies and establishes responsibilities for recording and maintaining contractor past performance information. It defines past performance information as relevant information for future source selection purposes regarding a contractor’s actions under previously awarded contracts. It includes the contractor’s history of reasonable and cooperative behavior and commitment to customer satisfaction, and generally, the contractor’s businesslike concern for the interest of the customer. Contractors in noncompetitive situations may refuse to provide DoD contracting officers with cost information required to determine price reasonableness (see finding B). The USD(AT&L) needs to address whether unreasonable and uncooperative contractors that refuse to provide either commercial sales information or “information other than cost or pricing data” to include cost information, should receive Red (unsatisfactory) out-of-cycle ratings in the Contractor Performance Assessment Reporting System (CPARS) under “Business Relations.”

## **Recommendations and Management Comments**

**A.1. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics develop and issue guidance in the acquisition regulations (Defense Federal Acquisition Regulation/Federal Acquisition Regulation) to:**

**a. Further clarify exceptions to cost or pricing data for noncompetitive commercial items that:**

**1. Address statutory requirements and provide instructions that contracting officers shall require submission of data other than certified cost or pricing data from the offeror or contractor. At a minimum, this data shall include appropriate information on the prices at which the same or similar items have previously been sold in the commercial market that is adequate for evaluating the reasonableness of the price of the procurement.**

**2. Establish Federal Acquisition Regulation 52-215.20 (ii), “Commercial Item Exception,” as a mandatory contract requirement in Federal Acquisition Regulation Part 12 contracts.**

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3. Instruct contracting officers to limit requests for information from the offeror or contractor on commercial sales to quantities similar to DoD annual demand quantities.

4. Instruct appropriate Government officials to make a determination whether any “of a type” item is sufficiently similar to the military item and any difference in price can be identified and justified. Any significant difference in similarity or price should be supported by cost analysis.

5. Instruct contracting officers to make a determination as to whether commercial sales information provided by the offeror or contractor is adequate to support a price reasonableness determination.

6. Instruct contracting officers to require additional “information other than cost or pricing data” from the offeror or contractor that includes cost information when the contracting officer makes a determination that commercial sales information is not adequate to support price reasonableness.

b. Further clarify pricing of noncompetitive commercial items as required by the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999 that:

1. Instructs contracting officers perform price analysis of commercial sales, when sales of the same or similar item previously sold in the commercial market are adequate for evaluating, through price analysis, the reasonableness of price and ensure the integrity of commercial sales information.

2. Instructs contracting officers to obtain “information other than cost or pricing data” which includes cost information and perform cost analysis if commercial sales are not adequate to determine price reasonableness. Price analysis of the previous Government price is acceptable if recent cost analysis or competition was used to support the price and there have been no known changes in the manufacturing process that could significantly impact the contractor’s costs.

A.2. We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics address whether unreasonable and uncooperative contractors that refuse to provide either commercial sales information or “information other than cost or pricing data” to include cost information, should receive “red” (unsatisfactory) out-of-cycle ratings in the Contractor Performance Assessment Reporting System under “Business Relations.”

**Management Comments.** The USD(AT&L) concurred with each recommendation and initiated efforts that should help DoD contracting professionals improve commercial item determinations, commercial item exceptions to cost or pricing data, and obtain appropriate information (that is, adequate commercial sales or cost information) to determine the price

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reasonableness of commercial noncompetitive spare parts. Specifically, the Director will meet with Senior Procurement Executives, deliberate a Federal Acquisition Regulation case, revise DoD procedures and guidance, re-energize the cost analysis and pricing function, and revise the contract pricing reference guide to satisfy the recommendations.

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## B. “Commercial” Pricing Strategy for Noncompetitive Spare Parts

The Air Force negotiating team used a high-risk “commercial” pricing strategy that failed to effectively use either marketplace pricing<sup>2</sup> or cost analysis for noncompetitive spare parts placed on the strategic sourcing contract with Hamilton Sundstrand. The Air Force did attempt to obtain cost information to support price reasonableness after the DoD OIG notified the Air Force of overpricing concerns based on two previous audits where contracting officers were not using either marketplace pricing or cost analysis to determine fair and reasonable prices for noncompetitive items. However, Hamilton Sundstrand denied the request and has repeatedly refused attempts by DoD contracting officials to obtain the information necessary to determine price reasonableness for noncompetitive spare parts. In July 2000, a similar strategic sourcing contract between DLA and Hamilton Sundstrand failed because an agreement on a pricing strategy could not be reached. The Air Force pricing strategy was ineffective because:

- “catalog” (marketplace) pricing was not used to support price reasonableness for any of the 1,011 “commercial” items placed on contract;
- cost data was obtained for only 34.4 percent of the annual dollar value for items with historical demand and a significant number of items had not been procured for extended periods or were manufactured at locations with newly established manufacturing standards that had not been audited, making any cost analysis less effective; and
- price analysis of questionable previous Government prices was used to support prices for 65.6 percent of the annual dollar value for items with historical demand, and prices for a significant number of the items had previously been determined not to be fair and reasonable.

As a result, we calculated that the contract prices for 93 items where price analysis was used, totaling more than \$7.5 million annually, were \$1.7 million or 28.4 percent higher than could be explained by inflating pre-FASA contract prices. We also calculated that price-based contract prices for two items with an annual value of \$1.4 million were \$950,283 or 214.2 percent higher than cost-based prices.

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<sup>2</sup> Information submitted by the offeror or contractor on prices at which the same item or similar items have been previously sold in the commercial market that is adequate for evaluating the reasonableness of price required by 10 U.S.C. 2306a(d)(1).

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## **“Commercial” Pricing Strategy**

**Contract Pricing Strategy.** The Air Force negotiating team used a high-risk “commercial” pricing strategy that failed to effectively use either marketplace pricing or cost analysis to price a sufficient percentage of the noncompetitive spare parts placed on the strategic sourcing contract with Hamilton Sundstrand. The pricing strategy used for Phase 1 of the contract was proposed by Hamilton Sundstrand and accepted by the Government with the intent to “standardize and simplify the process of providing price reasonableness information.” The objective of the pricing strategy was to “streamline the proposal and pricing process using price analysis and price-based pricing to the maximum extent practicable.” However, the strategy allowed Hamilton Sundstrand to provide cost data when it was beneficial to them but denied the Government access to cost data when it was in the Government’s best interest. The strategy included four pricing scenarios:

- Scenario 1—“Catalog”: Items listed in the Hamilton Sundstrand commercial catalog that had sales or offers in the past 3 years. Hamilton Sundstrand agreed to provide a copy of the catalog page and sales history, and may offer a discount off the catalog price.
- Scenario 2—Cost Data: Items with no sales or offer history in the past 3 years. Hamilton Sundstrand will provide “other than cost or pricing data,” including a summary of rates, material costs, and labor costs, as well as additional pricing details on a sample basis.
- Scenario 3—Price Analysis: Items with a sales or offer history in the past 3 years. The Government will use previous sales and proposal history to justify prices including using escalation and considering quantity differences. Hamilton Sundstrand will provide price history, such as a Haystack Procurement History Report or sales history to other customers, and, if appropriate, “other than cost or pricing data.”
- Scenario 4—Other: Items in the scenarios above where the quoted price increased more than 25 percent in the last 24 months. Hamilton Sundstrand will provide price justification and a written and/or verbal explanation for the price increase.

**Pricing Scenario Used for All Items.** The “catalog” pricing scenario was not used to support price reasonableness for any items. The Air Force analysis showed that the cost data scenario was used to support price reasonableness for 40.5 percent of the annual dollar value of the items, while price analysis was used to support price reasonableness for 59.5 percent of the annual dollar value (dollars) for Phase 1 items placed on contract. However, the data included a significant number of items with no known historical or forecasted demand.

Table 1 shows the Air Force data for the pricing strategy used to support price reasonableness for the Phase 1 contract items.

<b>Table 1. Pricing Strategy Used for All Phase 1 Items</b>			
<u>Scenario</u>	<u>Items</u>	<u>Annual Price</u>	<u>Percent</u>
1. "Catalog"	0	0	0.0
2. Cost-Based			
Purchased (Vendor			
Quotes)	510	\$ 1,943,115	9.9
Manufactured	184	6,008,495	30.6
Cost-Based Subtotal	694	7,951,610	40.5
3. Price Analysis			
Price-Based	254	11,415,845	58.2
"Catalog"	63	259,139	1.3
Price Analysis Subtotal	317	11,674,984	59.5
<b>Total</b>	<b>1,011</b>	<b>\$19,626,595*</b>	<b>100.0</b>

\*Slight rounding inconsistencies exist due to auditor calculations based on two decimal places.

**DoD OIG Calculations.** We determined that only 462 items with an annual price of \$16.3 million that were priced under Phase 1 of the contract had any historical or forecasted demand while 549 items valued at \$3.3 million had no known historical or forecasted demand. We determined that for the items with known historical or forecasted demand, none were priced using catalog or marketplace pricing, and calculated that 34.4 percent of the items (dollars) were priced using cost data while 65.6 percent of the items (dollars) were priced using price analysis. Table 2 shows our calculations for the items with historical demand.

<b>Table 2. DoD OIG Calculations of Pricing Strategy Used for Phase 1 Items With Historical or Forecasted Demand</b>			
<u>Scenario</u>	<u>Items</u>	<u>Annual Price</u>	<u>Percent</u>
1. "Catalog"	0	0	0.0
2. Cost-Based			
Purchased (Vendor Quotes)	161	\$ 1,187,272	7.3
Manufactured	55	4,437,313	27.2
Cost-Based Subtotal	216	5,624,585	34.4
3. Price Analysis			
Price-Based	224	10,498,915	64.3
"Catalog"	22	215,250	1.3
Price Analysis Subtotal	246	10,714,166*	65.6
<b>Total</b>	<b>462</b>	<b>\$16,338,751</b>	<b>100.0</b>

\*Slight rounding inconsistencies exist due to auditor calculations based on two decimal places.

Table 3 shows our calculations for the items with no known historical or forecasted demand.

<b>Table 3. DoD OIG Calculations of Pricing Strategy Used for Phase 1 Items With No Historical or Forecasted Demand</b>			
<u>Scenario</u>	<u>Items</u>	<u>Annual Price</u>	<u>Percent</u>
1. "Catalog"	0	0	0.0
2. Cost-Based			
Purchased (Vendor Quotes)	349	\$ 755,843	23.0
Manufactured	<u>129</u>	<u>1,571,182</u>	<u>47.8</u>
Cost-Based Subtotal	478	2,327,025	70.8
3. Price Analysis			
Price-Based	30	916,930	27.9
"Catalog"	<u>41</u>	<u>43,889</u>	<u>1.3</u>
Price Analysis Subtotal	71	960,819	29.2
<b>Total</b>	<b>549</b>	<b>\$3,287,844</b>	<b>100.0</b>

## Hamilton Sundstrand Actions

The Air Force attempted to obtain cost information to support price reasonableness after the DoD OIG notified the Air Force of overpricing concerns based on two previous audits where contracting officers were not using either marketplace pricing (price analysis of sufficient commercial sales) or cost analysis to determine fair and reasonable prices for noncompetitive items. However, Hamilton Sundstrand denied the request and has repeatedly refused attempts by DoD contracting officials to obtain the information necessary to determine price reasonableness for noncompetitive spare parts since the implementation of FASA and FARA. In July 2000, a similar strategic sourcing contract between DLA and Hamilton Sundstrand failed because agreement on a pricing strategy could not be reached. The following is a chronology of significant events relating to DoD contracting officials attempts to obtain cost information from Hamilton Sundstrand.

- September 11, 1996—Sundstrand (now Hamilton Sundstrand Corporation) withdraws from a spare parts pricing agreement with DSCP that uses cost data to price items based on the implementation of FASA.
- November 5, 1997—DoD OIG sends a memorandum to the Director, DLA expressing concern that the team negotiating prices for DLA corporate contract SP0700-98-D-9701 with Sundstrand (now Hamilton Sundstrand Corporation) for noncompetitive commercial items had not requested uncertified cost or pricing data.

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- November 7, 1997—The contracting officer for the negotiating team sends a letter to Sundstrand requesting uncertified cost or pricing data for 73 items where the negotiating team had been unable to support the prices as fair and reasonable.
  - November 10, 1997—Sundstrand accepts the Government’s last offer (fourth offer) of \$46.6 million instead of providing cost data. Sundstrand’s initial proposal (September 17, 1997) was \$91.9 million and the Government’s first offer (October 15, 1997) was \$28.1 million.
  - February 6, 1998—DoD Inspector General Report 98-064, “Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111,” finds that Sundstrand (now Hamilton Sundstrand Corporation) is refusing to provide DLA contracting officers with “uncertified” cost or pricing data and has terminated the Defense Contract Management Agency (DCMA), Rockford, Illinois, access to the Sundstrand cost history system.
  - May 2000—Hamilton Sundstrand refuses to provide the DSCC contracting officer uncertified cost data to reconcile differences in prices that could not be explained for contract SP0700-00-D-9713.
  - July 19, 2000—The Under Secretary of Defense for Acquisition Reform charts a rapid improvement team to develop a Strategic Supplier Alliance between DLA and Hamilton Sundstrand to obtain mutually advantageous pricing among other goals. However, the alliance fails because an agreeable pricing strategy could not be established. Specifically, Hamilton Sundstrand refused to provide commercial sales histories to determine whether a sufficient commercial market existed for marketplace pricing and also refused to provide uncertified cost data to establish fair and reasonable prices when a sufficient commercial market did not exist.
  - October 16, 2003—DoD Inspector General Report D2004-012, “Sole-Source Spare Parts Procured From an Exclusive Distributor,” shows that Hamilton Sundstrand directed contracting officers to procure its sole-source spare parts through its exclusive distributor, AAR Defense Systems. The exclusive distributor will provide cost data for its operations but is unable to obtain uncertified cost data to support Hamilton Sundstrand prices.
  - May 10, 2004—The DoD OIG informs the Director, Contracting Directorate, Ogden ALC, Hill Air Force Base, Utah, of concerns related to the ongoing negotiations of a long-term contract for “commercial” items with Hamilton Sundstrand based on two previous audit reports. Both reports addressed not obtaining sufficient cost information to support price reasonableness.
    - June 8, 2004—The Director of the Contracting Directorate, Ogden ALC, Hill Air Force Base, Utah, formally requests

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appropriate cost and pricing information that would be sufficient to determine price reasonableness for cost driver items under the Air Force strategic sourcing contract.

- June 10, 2004—The General Manager of Military Customer Support and Logistics for Hamilton Sundstrand states that the Air Force request for information other than cost or pricing data is an “unjustified departure” from the pricing agreement and should be discussed by the strategic supplier alliance executive committee prior to any unilateral request for uncertified cost information.
  - December 29, 2004—The Acting Director of the Contracting Directorate, Ogden ALC, Hill Air Force Base determines that the contractor had provided sufficient price comparison data to determine price reasonableness, and therefore they would proceed with awarding the contract.
- March 14, 2006—The DoD OIG briefs the Executive Director, Ogden ALC, Hill Air Force Base on preliminary audit results and concerns with the commercial pricing strategy for noncompetitive spare parts that had not established an effective means to determine price reasonableness.
  - March 15, 2006—The DoD OIG identifies 24 price-based parts with an annual price of \$5.9 million that have experienced questionable price increases. The OIG recommends that the Air Force obtain cost data for these items from Hamilton Sundstrand and also request that DCMA to review the cost data to determine whether the unexplained price increases are supportable.
  - March 30, 2006—The Director of Contracting, Ogden ALC, Hill Air Force Base requests that Hamilton Sundstrand provide cost data for the 24 price-based parts to substantiate that the negotiated contract prices are fair and reasonable.
  - April 11, 2006—Hamilton Sundstrand in a letter to the Director of Contracting, Ogden ALC, Hill Air Force Base refuses to provide the cost data requested by the Air Force.

FAR 15.403-4 provides contracting officers the authority to request information other than cost or pricing data or cost information when necessary to determine price reasonableness. Given the continued unwillingness of Hamilton Sundstrand to provide cost information when requested by senior DoD contracting officials, the Air Force needs to initiate action to develop alternate sources for noncompetitive Hamilton Sundstrand items. In addition, the Air Force needs to determine whether Hamilton Sundstrand should receive a “red” (unsatisfactory) out-of-cycle CPARS report in “Business Relations,” if the contractor’s behavior continues to be uncooperative and unreasonable in meeting requests for cost information.

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## **“Catalog” (Marketplace) Pricing**

Although Hamilton Sundstrand proposed prices based on a discount from their 2004 commercial catalog and the Air Force negotiating team identified 63 items fitting the “catalog” scenario, “catalog” (marketplace) pricing was not used to support price reasonableness for any of the “commercial” items placed on contract for Phase 1. According to the DSCR cost analyst, if the “catalog” items had previously been sold to the Government, the prior Government prices were used as the basis for pricing the items on the Air Force strategic sourcing contract (price analysis). Further, for items that did not have previous Government sales, the negotiating team generally agreed to a 50-60 percent discount from the catalog price. However, after reviewing the Hamilton Sundstrand 2006 commercial catalog, we determined that only 37 of the 63 items or 58.7 percent of the items were still listed in the catalog. Given the significant turnover in parts experienced in only 2 years, the usefulness of developing contract prices from the Hamilton Sundstrand catalog is questionable.

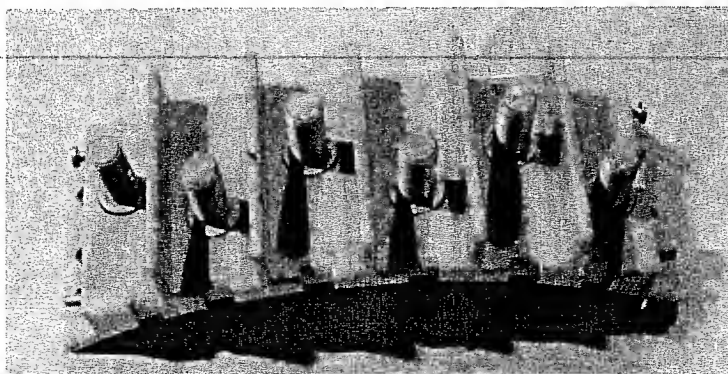
We found that the Hamilton Sundstrand commercial sales histories were inadequate to establish fair and reasonable prices because of insufficient commercial sales, most commercial sales prices were significantly higher than previous DoD prices, some commercial customers received significantly better prices than DoD, and contractors are not required to provide all relevant commercial sales data to ensure the integrity of the data.

**Insufficient Commercial Sales.** Hamilton Sundstrand had insufficient commercial sales to establish fair and reasonable prices to use marketplace pricing (price analysis of commercial sales). For example, the commercial sales history for terminal boards (NSN 5940-00-856-0853) showed commercial market sales of significantly lower quantities with an average buy quantity of 1.29 units and total commercial sales over 4 years (2000–2003) of only 27 units. In comparison, DoD purchased terminal boards in significantly higher quantities with an average buy quantity of 116.75 units and total purchases over 6 years (2000–2005) of 467 units. The DoD annual demand quantity for the terminal board is 75 units. Consequently, Hamilton Sundstrand did not have sufficient commercial sales to support marketplace pricing for the terminal boards.

Table 4 shows the terminal board sales history for commercial and DoD sales.

<b>Table 4. Commercial and DoD Sales History for Terminal Boards (NSN 5940-00-856-0853)</b>					
Commercial Market Sales					
<u>Calendar Year</u>	<u>Quantity</u>	<u>Number of Buys</u>	<u>Average Quantity</u>	<u>Unit Price</u>	<u>Total</u>
2000	5	4	1.25	\$794.18	\$ 3,971
2001	8	8	1.00	827.60	6,621
2002	11	6	1.83	830.64	9,137
2003	3	3	1.00	861.00	2,583
<b>Total</b>	<b>27</b>	<b>21</b>	<b>1.29</b>		<b>\$ 22,312</b>
Prior DoD Sales					
<u>Calendar Year</u>	<u>Quantity</u>	<u>Number of Buys</u>	<u>Average Quantity</u>	<u>Unit Price</u>	<u>Total</u>
2000	135	1	135.00	\$625.17	\$ 84,398
2002	7	1	7.00	625.17	4,376
2004	125	1	125.00	775.21	96,901
2005	200	1	200.00	775.21	155,042
<b>Total</b>	<b>467</b>	<b>4</b>	<b>116.75</b>		<b>\$340,717</b>
DoD Annual Demand Quantity for Air Force Strategic Sourcing Contract					
<b>Annual Demand</b>	<b>75</b>			<b>\$794.59</b>	<b>\$ 59,594</b>

Figure 1 shows the terminal board (NSN 5940-00-856-0853).

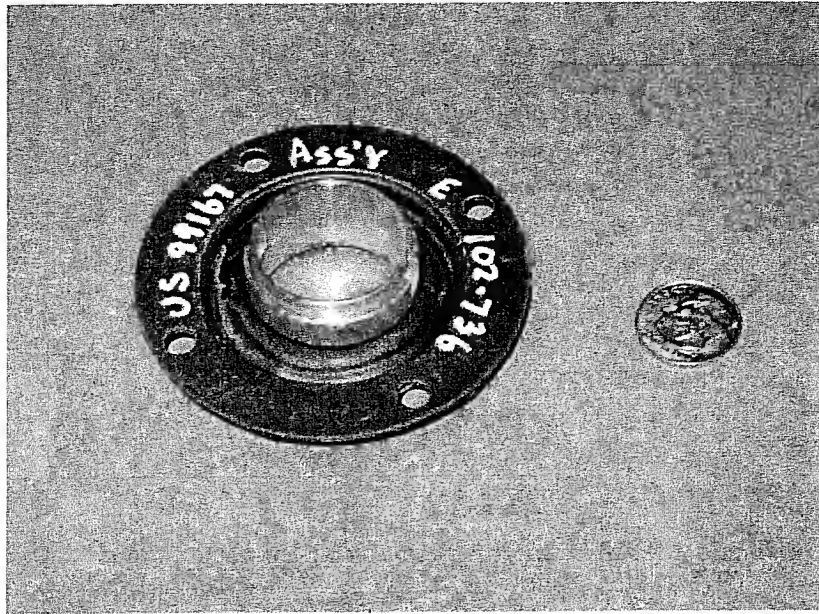


**Figure 1. Terminal Board Supplied by Hamilton Sundstrand**

**Sufficient Commercial Sales but Higher Commercial Prices.** We identified an instance where there appeared to be sufficient commercial sales to

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support marketplace pricing; however, the prices paid by the commercial customers were significantly higher than previous DoD prices. For example, in 2001–2002, DSCR purchased 809 pump diaphragm assemblies (NSN 2915-00-877-3760) for \$237.29 each. Figure 2 shows the pump diaphragm assembly (NSN 2915-00-877-3760).



**Figure 2. Pump Diaphragm Assembly Supplied by Hamilton Sundstrand**

During the same time period, Hamilton Sundstrand showed commercial sales of 1,204 assemblies to part distributors and foreign companies at unit prices ranging from \$736.26 to \$1,014.67 or 210 to 328 percent higher than the previous Government prices. It will be difficult to justify the use of commercial marketplace pricing if previous Government prices are significantly lower than commercial prices.

**Obtaining the Best Commercial Price.** We also identified several instances where DoD negotiated prices were significantly higher than the prices paid by some commercial customers. For example, the strategic sourcing contract unit price for a straight headless pin (NSN 5315-01-314-3829) is \$15.05 based on the annual demand of two. In 2003, DoD purchased 37 pins for \$13.85 each. However, in December 2002, Hamilton Sundstrand sold two pins for \$3.88 each to a commercial customer. As a result, we calculated that the negotiated price on the strategic sourcing contract was 288 percent higher than the best commercial customer price.

Similarly, the strategic sourcing contract unit price for an induction coil armature (NSN 5945-01-505-9210) is \$266.38, while the only previous commercial sale of the part shows a unit price of \$95.90 for 15 armatures. We calculated the strategic sourcing contract negotiated price was 177.8 percent higher than the best commercial customer price.

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**Integrity of Commercial Sales Data.** DoD has no means to ensure the integrity of commercial sales data. Specifically, there is no guarantee that the contractor will provide all commercial sales data, including sales to OEMs and prime contractors. In addition, for “of a type” items, there is no assurance that the contractor provides all similar items sold in comparable or large quantities that have lower commercial sales prices. Further, when performing price analysis of commercial sales, the terms and conditions of commercial sales must be reviewed to determine their impact on pricing.

The failure of the Air Force to use commercial marketplace pricing (Scenario 1) for a significant number of items and the difficulty in effectively using the pricing strategy for even a limited number of items that meet the criteria is a clear indicator that a commercial procurement strategy was not appropriate to obtain fair and reasonable prices for these noncompetitive spare parts. Commercial contracts should only be used when sufficient commercial marketplace sales are available to effectively develop fair and reasonable prices for a significant number or percent of the total contract dollar amount.

## **Cost Data**

The Air Force negotiating team obtained cost data for 34.4 percent of the annual dollar value for items with historical or forecasted demand and a number of items had not been procured for extended periods or were manufactured at locations with newly established manufacturing standards that had not been audited, making any cost analysis less effective. We also found instances where the cost data used was questionable because Hamilton Sundstrand vendor quotes consistently failed to include economic order quantities, savings gained from manufacturing decisions were not shared with DoD, and significant demand changes exist that could affect the reasonableness of negotiated contract prices. Further, cost data was obtained for a significant number of items with no known or forecasted demand.

The strategic sourcing pricing strategy required Hamilton Sundstrand to provide uncertified cost data for items that had no sales or offer history within the previous 3 years. Unfortunately, the less frequently an item is manufactured or procured, the higher the risk of obtaining unreliable cost information.

Our review shows that prices for purchased parts (vendor quotes) and manufactured parts at locations other than Puerto Rico decreased by 13.9 and 6.0 percent respectively when adjusted for inflation where cost data was used. Prices for parts manufactured in Puerto Rico increased by 38.4 percent when adjusted for inflation.

Table 5 shows a summary of the parts reviewed where cost data was provided.

<b>Table 5. Summary of Cost-Based Parts Reviewed</b>				
		<u>Total Contract Price</u>		<u>Percent</u>
	<u>Items</u>	<u>Previous</u>	<u>Air Force*</u>	<u>Difference</u>
Purchased Parts (Vendor Quotes)	21	\$ 802,111	\$ 690,887	(13.9)
Manufactured Parts – Other Locations	4	345,832	325,094	(6.0)
Manufactured Parts – Puerto Rico	<u>11</u>	1,380,781	<u>1,911,384</u>	38.4
<b>Total</b>	<b>36</b>		<b>\$2,927,365</b>	

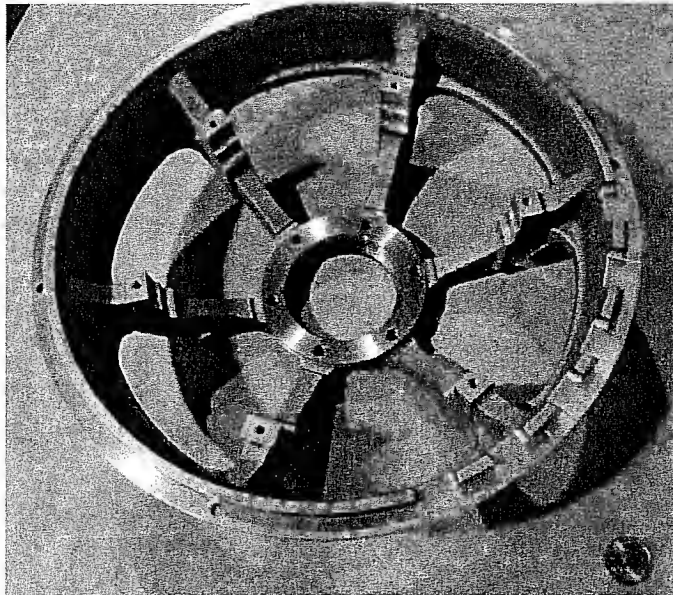
\*For consistent comparisons, we calculated the Air Force total price by multiplying the annual demand quantity and the Air Force contract price that corresponded to the quantity of the previous contract.

**Purchased Parts (Vendor Quotes).** The cost data provided by Hamilton Sundstrand for the 21 purchased parts consisted primarily of recent vendor quotes. DoD had purchased the majority of these items in recent years but the vendor quotes were not compared to previous Hamilton Sundstrand purchase order prices to identify economic order quantities. For example, the Air Force negotiated a unit price of \$628.39 for an electrical rotating end bell (NSN 6115-00-474-0736) with an annual demand quantity (ADQ) of 42 for an annual price of \$26,392. However, the vendor quote (cost data) used to support the initial price shows an unburdened unit price of \$1,771 with only one quantity range of 1–30 and the Defense Contract Audit Agency (DCAA) recommended burdened unit price was \$2,665.92. The DSCR cost analyst stated Hamilton Sundstrand was requested to provide an additional vendor quote for a quantity of 40 and the revised vendor quote of \$449.00 supported the negotiated price. Table 6 shows the pricing information for this item.

<b>Table 6. Pricing for an Electrical Rotating End Bell (NSN 6115-00-474-0736) – ADQ 42</b>			
<u>Source</u>	<u>Date</u>	<u>Quantity</u>	<u>Unit Price</u>
Vendor Quote*	11/14/2003	Range 1–30	\$1,771.00
DCAA Recommended Price	3/1/2004	Range 1–32	2,665.92
Hamilton Sundstrand Purchase Order	2/24/2004	48	402.00
Procurement History	1/30/2004	48	484.89
Revised Vendor Quote*		40	449.00
Air Force Contract	3/1/2005	Range 1–32	628.39

\*Vendor Quotes do not include Hamilton Sundstrand profit and burden.

Figure 3 shows a picture of the Electrical Rotating End Bell.



**Figure 3. Electrical Rotating End Bell Supplied by Hamilton Sundstrand**

Hamilton Sundstrand provided a vendor quote for an electrical winding wedge (NSN 6150-01-503-6636) with a quantity range of 1–35 at a unit price of \$124.85 and DCAA provided a recommended burden unit price of \$187.94. However, the Air Force negotiating team used price analysis to establish the negotiated unit price of \$121.98, totaling an annual price of \$50,256 based on an ADQ of 412. Table 7 shows the pricing information for this item.

**Table 7. Pricing for an Electrical Winding Wedge  
(NSN 6150-01-503-6636) - ADQ 412**

<u>Source</u>	<u>Date</u>	<u>Quantity</u>	<u>Unit Price</u>
Vendor Quote*	11/21/2003	Range 1–35	\$124.85
DCAA Recommended Price	3/1/2004	Range 1–35	187.94
Procurement History	1/16/2004	300	118.87
Air Force Contract	3/1/2005	Range 1–8	121.98

\* Vendor Quote does not include Hamilton Sundstrand profit and burden.

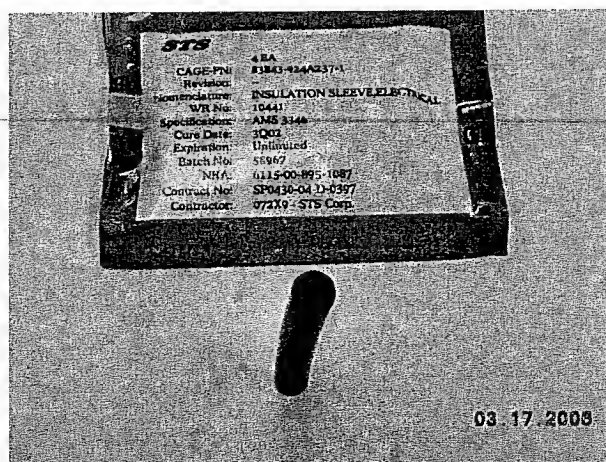
We reviewed the pricing for two additional items outside the cost-based parts selected for review because of requests by Air Force or DLA officials. During price negotiations, the contracting officials did not review the specific vendor quote for insulation sleeves (NSN 5970-01-505-8103) used on the T-38 aircraft and relied on the agreed-upon pricing methodology to establish a contract price of \$85.02 based on the contract ADQ of one. After our request, the Air Force

contracting officer obtained the vendor quote from Hamilton Sundstrand. To support this price, Hamilton Sundstrand provided a vendor quote showing a unit price of \$60.25 each based on the contract ADQ of one. However, the ADQ used to price the item is not accurate and Hamilton Sundstrand failed to provide economic order quantities to help obtain a reasonable price. In December 2004, the Air Force purchased 44 insulation sleeves at a unit price of \$8.51 on contract F34601-02-G-0004. The negotiated contract unit price of \$85.02 is 899.1 percent more than the most recent procurement. In addition, DLA data shows the historical ADQ for the item is 22 and through March 2006, 168 sleeves have been purchased under the strategic sourcing commercial contract. Based on a comparison with the previous unit price, we calculated that DLA paid at least \$12,870 more than necessary for the 168 insulation sleeves purchased under the commercial contract. Clearly, significantly better pricing could have been negotiated for this item if more economical quantity ranges were quoted. Table 8 shows the pricing of an insulation sleeve used on the T-38 aircraft.

<b>Table 8. Pricing for Insulation Sleeve (NSN 5970-01-505-8103) – ADQ 22</b>				
<u>Source</u>	<u>Date</u>	<u>Quantity</u>	<u>Unit Price</u>	<u>Total Price</u>
Vendor Quote <sup>1</sup>	12/23/2003	1	\$60.25	
Procurement History	12/3/2004	44	8.51	\$ 374
Air Force Contract	3/1/2005	Range 1–3	85.02	
Purchases on Contract		168	85.12 <sup>2</sup>	14,300

<sup>1</sup>Vendor Quote does not include Hamilton Sundstrand profit and burden.  
<sup>2</sup>Weighted average unit price. The contract unit price was escalated to \$85.13 in 2006.

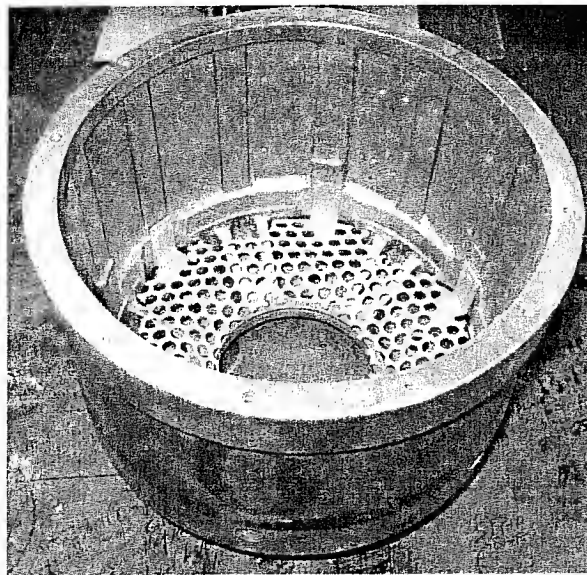
Figure 4 shows a picture of the Insulation Sleeve (NSN 5970-01-505-8103).



**Figure 4. Insulation Sleeve for the T-38 Aircraft Supplied by Hamilton Sundstrand**

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In addition, the contracting officials also negotiated the contract unit price of \$5,203.68 for the T-38 generator housing (NSN 6150-01-503-6756) based on the pricing methodology and did not review the actual vendor quote during price negotiations. Again, the Air Force contracting officer obtained the vendor quote from Hamilton Sundstrand after our request. Hamilton Sundstrand again provided a vendor quote for a quantity of one with the \$3,696 unit price based on the contract ADQ to support the contract price and failed to provide any economical quantity ranges. Because of the uneconomical price, the Air Force engineer contacted a local manufacturer and stated that the item can be purchased from the local manufacturer for about \$300 each. The Air Force is pursuing the breakout of this item. Figure 5 shows the housing produced by the local manufacturer.



**Figure 5. Housing for the T-38 Generator**

**Economic Order Quantities.** The statutory requirement for procuring items in economic order quantities is 10 U.S.C. 2384a, "Supplies: economic order quantities." Specifically, the requirement states:

(a)(1) An agency referred to in section 2303 (a) of this title shall procure supplies in such quantity as (A) will result in total cost and unit cost most advantageous to the United States, where practicable, and (B) does not exceed the quantity reasonably expected to be required by the agency.

(2) The Secretary of Defense shall take paragraph (1) into account in approving rates of obligation of appropriations under section 2204 of this title.

(b) Each solicitation for a contract for supplies shall, if practicable, include a provision inviting each offeror responding to the solicitation

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to state an opinion on whether the quantity of the supplies proposed to be procured is economically advantageous to the United States and, if applicable, to recommend a quantity or quantities which would be more economically advantageous to the United States. Each such recommendation shall include a quotation of the total price and the unit price for supplies procured in each recommended quantity.

In order to comply with the statute, the Air Force and DLA need to require that Hamilton Sundstrand obtain vendor quotes with economical order quantities to establish part prices. The Air Force needs to request that DCMA review negotiated Phase 1 prices for purchase parts to determine the cost realism for all vendor quotes that did not have economic order quantities.

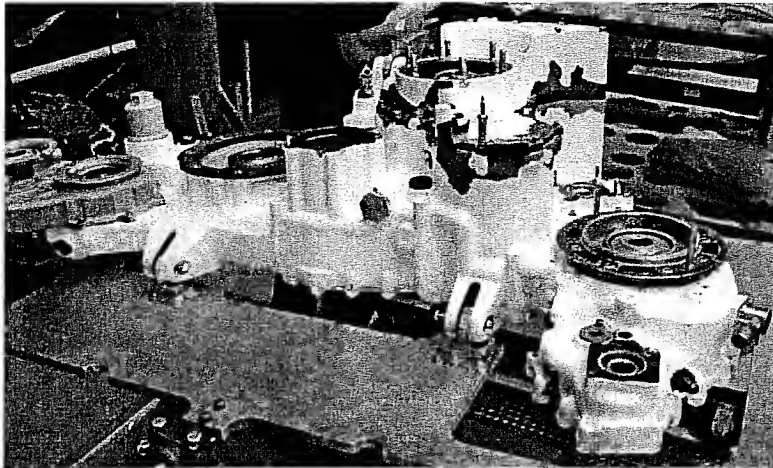
**Manufactured Parts – Other Locations.** Hamilton Sundstrand provided “estimated cost information” for four parts in our review that were manufactured at locations other than Puerto Rico. Two of these parts experienced changes in manufacturing or significant demand changes that could affect the reasonableness of negotiated contract prices, while another part apparently did not use cost information to negotiate the contract price.

A wedge holding (NSN 6115-01-145-3815) had an ADQ of 3,030 and a negotiated unit price of \$42.86 for an annual price of \$129,866. The cost information supported the negotiated price. However, based on 2006 cost standards, Hamilton Sundstrand no longer manufactures the item and instead purchases the item directly from one of its subcontractors. The item now has a lower standard unit cost of \$20.62. After applying the negotiated burden and profit rates for the strategic sourcing contract, we calculate the item’s unit price should be \$31.04. Unfortunately, Hamilton Sundstrand did not pass the savings gained from the change in manufacturing to DoD. As a result, based on the ADQ of 3,030, we calculated that the negotiated price will result in DoD annually paying \$35,815 more than necessary for this item. The Air Force should request DCMA review this item and adjust contract prices accordingly. The wedge holding is pictured in Appendix C figure C-1.c.3.

The accessory drive gearbox housing for the F-16 turbine engine (NSN 2835-01-208-4430) had an ADQ of four and a negotiated unit price of \$44,136.20 for an annual price of \$176,545. The labor standards were reviewed by DCMA who recommended changes that lowered the price by about \$2,500 each; the cost information was used to support the negotiated price. However, the manufacturing cost standards appear to be questionable because prior purchase quantities were significantly lower than the Air Force planned purchase quantity. The last purchase before the strategic sourcing contract occurred in January 1999, when the Air Force purchased four gearboxes at a unit price of \$37,936.27, totaling \$151,745. The largest quantity purchased since 1982, is eight. As a result, the Hamilton Sundstrand cost standard will be based on low quantities and not include any manufacturing efficiencies. However, the Air Force is planning to purchase 88 gearboxes over the next 3 years, totaling almost \$4 million. Given the significant dollar value, the Air Force needs to request that DCMA re-visit the contractor “estimated cost information” in the near future and adjust the contract price if necessary.

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Figure 6 shows the accessory drive gearbox used on the F-16 aircraft.



**Figure 6. The F-16 Aircraft Accessory Drive Gearbox in Repair**

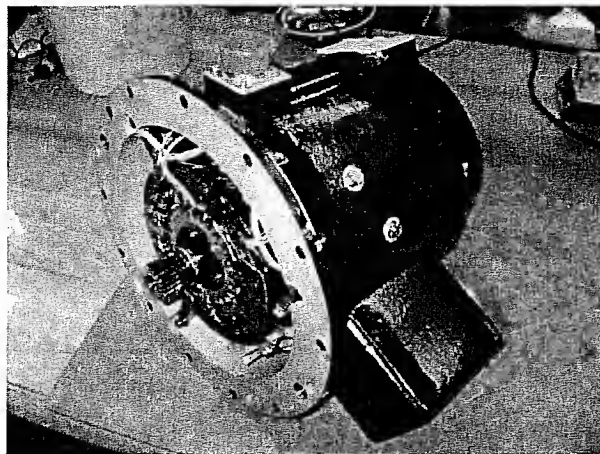
A seal housing assembly (NSN 2835-01-051-6443) had an ADQ of two and a negotiated unit price of \$113.21 for an annual price of \$226. The cost information provided supported a unit price of \$325.07. The Air Force had procured 14 assemblies in December 2004 also at a price of \$113.21, so it appears the cost information was not used to establish the contract price.

A spur gear (NSN 3020-01-059-5171) had an ADQ of 46 and a negotiated unit price of \$401.23 for an annual price of \$18,457. The labor standards were also reviewed by DCMA; the cost information generally supported the negotiated price.

**Manufactured Parts – Puerto Rico.** Hamilton Sundstrand provided cost information for parts manufactured in Puerto Rico, but several of the items had significant gaps between purchases. For example, the alternating current generator (NSN 6115-01-149-7588) used on the B-1B aircraft had not been purchased since May 1989, when the Air Force purchased 41 generators at a unit price of \$16,310, totaling \$668,710. Using cost information, the Air Force contracting officer negotiated a contract unit price of \$38,535.79 based an ADQ of 11, totaling \$423,894.

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Figure 7 shows the alternating current generator used on the B-1B aircraft.



**Figure 7. B-1B Aircraft Alternating Current Generator**

Similarly, another alternating current generator (NSN 6115-01-104-8632) used on the E-3, E-8, and KC-135 aircraft had not been purchased since April 1991, when the Air Force purchased 11 at a unit price of \$12,850, totaling \$141,350. Using cost information, the Air Force contracting officer negotiated a contract unit price of \$30,857.14 based on an annual demand value of seven, totaling \$216,000. There were also several items that had been recently purchased in 2004–2005, months prior to the Air Force commercial contract award, which also had experienced significant gaps in purchases before the most recent award.

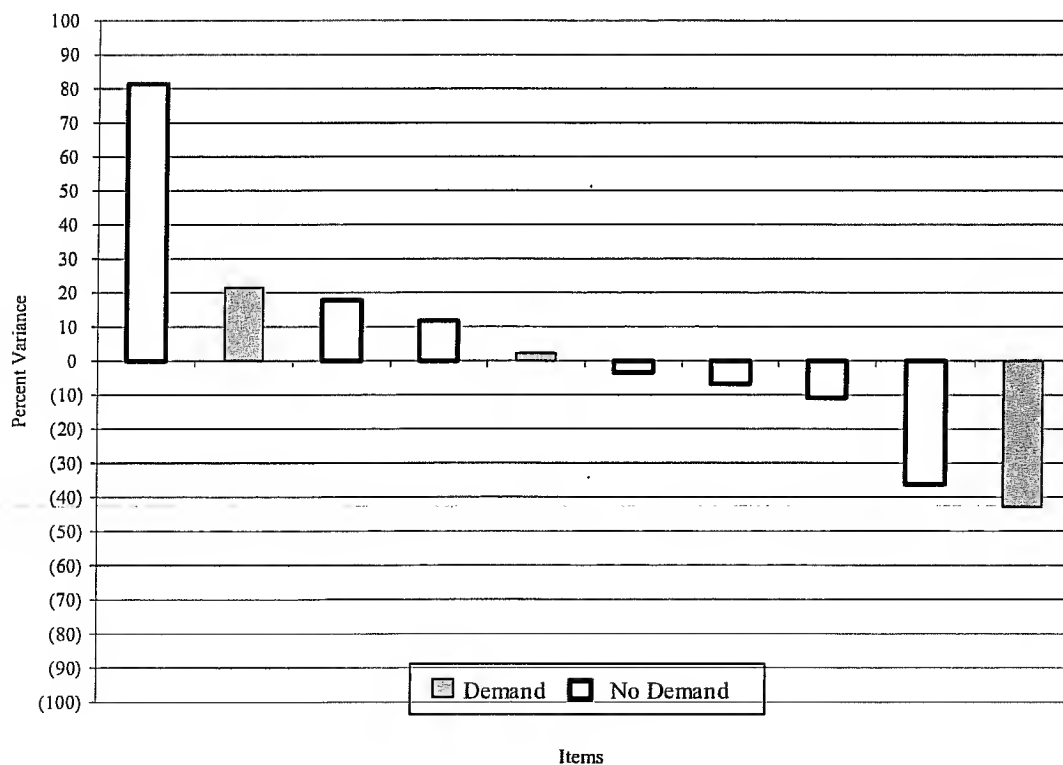
Hamilton Sundstrand provided “estimated cost information” and DCMA evaluated this information for 2 of the 11 parts manufactured in Puerto Rico that we reviewed. For example, an armature exciter (NSN 6115-01-080-8643) used on the A-10 aircraft had an ADQ of 107 and a negotiated unit price of \$2,313.64 for an annual price of \$247,559. The proposed labor standards were reviewed by DCMA and the part was manufactured entirely in Puerto Rico. The estimated cost information supported the negotiated contract price.

Similarly, an alternating current generator (NSN 6115-01-246-5622) used on the F-16 aircraft had an ADQ of four and a negotiated unit price of \$22,928.41 for an annual price of \$91,714. The proposed labor standards were reviewed by DCMA who recommended changes that reduced the unit price by about \$1,000–\$2,000 based on order quantities. The estimated cost information supported the negotiated contract price. For more information on pricing issues related to generators and generator components see Appendix C.

**DCAA and DCMA Audit Support.** The Air Force contracting officer requested that DCAA review cost data for 17 manufactured items with a total annual price of about \$2.2 million. DCAA then requested that DCMA review the labor standards for the items. We found that one item with an annual price of \$401,478 was switched to price-based after the cost data was submitted and that 10 of the items valued at about \$1.3 million had no historical or forecasted demand. The

remaining six items had an annual price of \$555,687. DCMA verified that the labor standards in the Hamilton Sundstrand accounting system matched the labor proposed in cost data provided to contracting officers and DCAA verified that the material quotes matched the standards. The DCMA industrial engineer adjusted the proposed labor hours for 13 of the 17 items (76.5 percent) and DCAA recommended changes to material costs for the majority of items. Subsequently, DCAA recomputed the prices based on the DCMA recommended labor hours and more current forward pricing rates.

In the March 15, 2004, report, the DCMA industrial engineer stated that the Puerto Rico manufacturing facilities had changed to standard costs recently and that an in-depth review of the sites had not been performed to ensure the accuracy of the standards being used. We compared transition standards in the 2003–2004 timeframe and found significant fluctuations in the standards for 10 items manufactured in Puerto Rico. Out of the 10 items reviewed, 7 did not have historical demand. Figure 8 shows the percent change in cost standards for the 10 items.



**Figure 8. Percent Change in Puerto Rico Manufacturing Standards From 2003–2004 for 10 items**

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Given the significant fluctuations in the standard costs for items manufactured in Puerto Rico shown in Figure 8, the Air Force should request that DCMA reevaluate cost data for these items in a few years once it has reviewed the standards and more current information is available. In March 2006, DCMA began a review of the Puerto Rico cost standards.

Basing long-term contract prices on newly established standards that have not been audited and items that do not have historical demand is higher risk because the initial cost standards can fluctuate significantly. Cost data is most effective when the standards are based on recent and consistent manufacturing history. In addition, DCAA and DCMA audit resources should be focused on high dollar and frequent demand items. The Air Force needs to request that DCMA review contractor "estimated cost information" for items manufactured in Puerto Rico after manufacturing standards have been audited and adjust contract prices if necessary.

**No Historical or Forecasted Demand.** As shown previously in Table 3, the Air Force negotiating team negotiated prices for 549 items valued at \$3.3 million that had basically no historical or forecasted demand. Cost data were used to support prices for 478 of the items valued at \$2.3 million. According to DLA personnel, Ogden ALC and Hamilton Sundstrand engineers provided input to the demand development for the 549 items. The contracting officers then relied on this demand and included the items in Phase 1 of the strategic sourcing contract. Our review of procurement histories showed that the large majority of the 549 items had not been purchased previously by DoD. Based on the acquisition advice codes, these items will not be procured until there is a backorder or actual requirement. Through January 2006, only 11 of the 549 items had actually been purchased under the strategic sourcing contract. We question the inclusion of these items in Phase 1 of the contract when no forecasted or historical demand exists.

Also, the reliability of cost data for items that have never been purchased is questionable and not a good basis for establishing prices on a long-term contract. In addition, expending both time and effort negotiating prices for these parts that had no historical demand is a questionable use of both DoD and contractor resources. Contracting officers should purchase these items from Hamilton Sundstrand on an as-needed basis until forecasted demand levels can be established. The Air Force needs to discontinue pricing items with no historical or forecasted demand.

## Price Analysis

The Air Force negotiating team used price analysis of previous Government prices to support prices for 65.6 percent of the annual dollar value for items with historical and forecasted demand as required by the negotiated pricing strategy. However, a significant number of the previous noncompetitive procurements had been determined not to be fair and reasonable. Price analysis of previous Government prices is only effective when the validity of the comparison price can be established.

**Previous Government Prices.** The Air Force negotiating team relied on prices that were previously determined to be unreasonable as a basis for establishing the strategic sourcing contract prices. Out of 109 DLA managed items that had a total annual price of about \$12.0 million, we reviewed 83 items with an annual price of \$10.8 million. After reviewing procurement histories, a previous corporate contract, and price reasonableness codes for the 83 items, we determined that 36 items (43 percent) with an annual price of about \$6.3 million or 57.9 percent of the annual demand dollars relied on prior Government prices that had been coded either “could not determine reasonable” or “determined unreasonable” by DLA contracting officers.

For example, in November 1997, the DLA buyer determined that the price for an armature generator (NSN 6115-00-856-8519) could not be determined to be fair and reasonable. Subsequent buys were then determined either unreasonable or could not be determined reasonable as the price increased. However, the Air Force negotiating team used the November 2002 contract that had been determined unreasonable to negotiate the item’s price on the strategic sourcing contract. As a result, the Air Force-negotiated price was 103.8 percent higher than the 1997 price that could not be determined reasonable. Table 9 shows the price reasonableness determinations made for the armature generator since 1997.

<b>Table 9. Price Reasonableness Determinations for the Armature Generator (NSN 6115-00-856-8519)</b>			
<u>Date</u>	<u>Unit Price</u>	<u>DLA Buyer Code-Definition</u>	<u>Percent Increase</u>
11/17/1997	\$ 996.16	BV-Could Not Determine Reasonable	
3/18/1998	1,286.55	BU-Determined Unreasonable	29.2
11/28/2001	1,691.00	BV-Could Not Determine Reasonable	69.8
11/4/2002	1,946.56	BU-Determined Unreasonable	95.4
3/1/2005	2,030.34	Air Force Strategic Sourcing Contract	103.8

**Validity of Comparison Price.** FAR-15.404-1(b)(2)(ii), requires that contracting officers validate the comparison and reasonableness of the prior Government price when performing price analysis. Specifically, the Regulation states:

Comparison of previously proposed prices and previous Government and commercial contract prices with current proposed prices for the same or similar items, **if both the validity of the comparison and the reasonableness of the previous price(s) can be established.** [emphasis added].

**Reasonableness of Negotiated Prices.** Price analysis did not provide the Air Force negotiating team with sufficient information to support price reasonableness for noncompetitive spare parts on the strategic sourcing contract. We calculated that negotiated prices for 93 price-based items on Phase 1 of the strategic sourcing contract with an annual price of more than \$7.5 million were

\$1.7 million or 28.4 percent higher than fair and reasonable prices calculated by inflating pre-FASA contract prices using the Producer Price Index for Aircraft Engines and Parts. See Appendix A for more discussion on the specific details of this analysis. Table 10 shows a summary for 93 parts sorted by percent increase.

**Table 10. Price Analysis of Air Force Contract Price-Based Items**

Range of Percent <u>Increase</u> <u>(Decrease)</u>	Percent			Total Price		
	<u>Items</u>	<u>Items</u>	<u>Total Price</u>	<u>Previous Contract</u> <sup>1</sup>	<u>Air Force Contract</u> <sup>2</sup>	<u>Percent Difference</u>
100+	19	20.4	24.8	\$ 751,207	\$1,873,027	149.3
50-99	12	12.9	22.3	1,024,522	1,683,308	64.3
0-49	32	34.4	29.4	1,830,987	2,219,770	21.2
(1-68)	30	32.3	23.4	2,268,597	1,769,085	(22.0)
<b>Total</b>	<b>93</b>			<b>\$5,875,312<sup>3</sup></b>	<b>\$7,545,191<sup>3</sup></b>	<b>28.4</b>

<sup>1</sup>The previous contract prices were inflated based on the Bureau of Labor Statistics Producer Price Index for Aircraft Engines and Parts midpoint factors.

<sup>2</sup>For consistent comparisons, we calculated the Air Force total price by multiplying the annual demand quantity and the Air Force contract price that corresponded to the quantity of the previous contract.

<sup>3</sup>Slight rounding inconsistencies exist due to auditor calculations based on two decimal places.

For comparison purposes, we also used a strategic sourcing contract between DLA and Honeywell for noncompetitive spare parts where cost-based pricing is used. The DLA/Honeywell strategic sourcing agreement used FAR Part 15 contracts with some commercial clauses and there were no commercial item determinations. High dollar-value parts were priced using cost analysis and low dollar-value parts were priced using price analysis. Generally, 20 percent of the items represent 80 percent of the dollars while the remaining 80 percent of the items represent only 20 percent of the dollars. Cost analysis was focused on the 20 percent of the items that represented 80 percent of the dollars, although cost analysis could be performed on any item.

We calculated that negotiated prices for 432 items on the strategic sourcing contract with an annual price of about \$53.3 million were only \$703,926 or 1.3 percent higher than pre-FASA prices inflated using the Producer Price Index for Aircraft Engines and Parts. Further, prices for 47.2 percent of the items and 44.1 percent of the dollars had actually decreased when adjusted for inflation (Table 11).

<b>Table 11. Price Analysis of DLA-Honeywell Contract Cost-Based Items</b>						
Range of Percent Increase (Decrease)	Percent			Total Price		
	Items	Items	Total Price	Previous Contract <sup>1</sup>	DLA Contract <sup>2</sup>	Percent Difference
100+	60	13.9	15.8	\$ 3,121,188	\$ 8,416,740	169.7
50-99	51	11.8	10.2	3,115,855	5,419,909	73.9
0-49	117	27.1	29.9	13,137,251	15,914,470	21.1
(1-68)	<u>204</u>	47.2	44.1	<u>33,198,045</u>	<u>23,525,147</u>	(29.1)
<b>Total</b>	<b>432</b>			<b>\$52,572,339</b>	<b>\$53,276,266</b>	<b>1.3</b>

<sup>1</sup>The previous contract prices were inflated based on the Bureau of Labor Statistics Producer Price Index for Aircraft Engines and Parts midpoint factors.

<sup>2</sup>For consistent comparisons, we calculated the DLA total price by multiplying the annual demand quantity and the DLA contract price that corresponded to the quantity of the previous contract.

The DLA/Honeywell strategic sourcing contract has over 10,000 items with negotiated prices and has resulted in significant reductions in workload for DLA and Honeywell, reduced administrative lead time, less inventory, and lower prices.

The Air Force strategic sourcing commercial contract showed price increases of 28.4 percent when price analysis was used while the DLA strategic sourcing contract showed price increases of only 1.3 percent when cost analysis was used to establish prices. The 28.4 percent increase, if reasonable, needs to be supported by cost analysis.

**San Diego Items.** Our review included 11 items supplied by Hamilton Sundstrand's San Diego, California, facility. The 11 items had an annual price of more than \$4.7 million or about 24 percent of the total contract demand of \$19.6 million (Table 1). The contracting officials used price analysis to establish prices for 7 of the 11 items and used cost information to establish prices for the other 4 items.

Table 12 identifies the items we reviewed by Air Force negotiating team pricing method.

Table 12. Pricing of San Diego Items			
NSN	ADQ	Air Force Contract Price	
		Unit	Total
Price-Based			
1560-01-109-2530	640	\$ 76.83	\$ 49,171
2835-00-963-1173	202	241.73	48,829
2835-01-208-7789	421	2,357.50	992,508
2835-01-288-1642	448	1,258.70	563,898
2835-01-329-2486	164	2,967.38	486,650
2835-01-459-6002	97	4,138.95	401,478
2915-01-157-3703	987	187.10	184,668
Subtotal Price-Based			\$2,727,202
Cost-Based			
2835-01-056-8593	37	\$ 1,933.44	\$ 71,537
2835-01-310-0117	316	3,598.00	1,136,968
2835-01-467-7434	247	3,181.00	785,707
2910-01-135-5681	1	12,210.00	12,210
Subtotal Cost-Based			\$2,006,422
Total			\$4,733,624

We performed cost analysis on 3 parts (2 price-based and 1 cost-based) with an annual price of about \$2.5 million or 53.5 percent of the annual price for the 11 San Diego items. Table 13 shows the negotiated prices for the two price-based items were 214.2 percent higher than fair and reasonable while the negotiated price for the cost-based item was in line with our cost analysis.

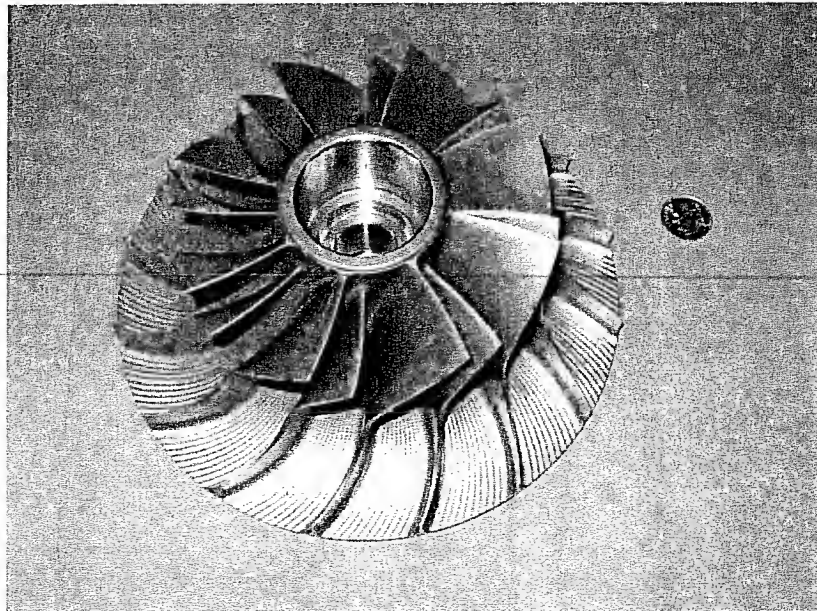
Table 13. Comparison of Contract and Cost-Based Prices							
NSN	ADQ	Air Force Contract		Cost-Based Price		Difference	
		Unit	Total	Unit	Total	Amount	Percent
Price-Based							
2835-01-208-7789	421	\$2,357.50	\$ 992,508	\$ 648.63	\$ 273,073	\$719,434*	263.5
2835-01-459-6002	97	4,138.95	<u>401,478</u>	1,759.06	<u>170,629</u>	<u>230,849</u>	<u>135.3</u>
Total Price-Based			\$1,393,986		\$ 443,702	\$950,283	214.2
Cost-Based							
2835-01-310-0117	316	\$3,598.00	\$1,136,968	\$3,570.09	\$1,128,149	\$ 8,819	0.8
*Slight rounding inconsistencies exist due to auditor calculations based on two decimal places.							

For a compressor wheel (NSN 2835-01-459-6002), Hamilton Sundstrand initially proposed the pricing based on cost information because the part number assigned to the item (162690-1) did not show any Government sales within the last 3 years. However, Hamilton Sundstrand later stated that the manufacturer part number for this item changed (4502902) because of a “material change” and the new part number had recent previous Government sales on which to develop a price-based price through price analysis. Our review of the bills of materials for both part numbers showed the major material components to be the same. Price analysis shows a 4.1 percent reduction in the negotiated price. However, using the cost data, we calculated that the fair and reasonable unit price should have been \$1,759.06 versus the negotiated price of \$4,315.78 or a difference of 135.3 percent. Table 15 shows the comparison.

<b>Table 15. Comparison of Air Force Pricing Method and Cost Data for the Compressor Wheel (NSN 2835-01-459-6002)</b>							
		<u>Air Force Contract</u>		<u>Comparison Price</u>		<u>Difference</u>	
	<u>AD</u>	<u>Unit</u>	<u>Total</u>	<u>Unit</u>	<u>Total</u>	<u>Amount</u>	<u>Percent</u>
Price-Based	97	\$4,138.95	\$401,478	\$4,315.78*	\$418,631	(\$ 17,153)	(4.1)
Cost Data	97	4,138.95	401,478	1,759.06	170,629	230,849	135.3

\*The most recent procurement was purchased from AAR, Hamilton Sundstrand's exclusive distributor, who applies a 20 percent management fee to the price. We removed this management fee from the unit price in the comparison.

Figure 10 shows the compressor wheel used on the F-16 aircraft.

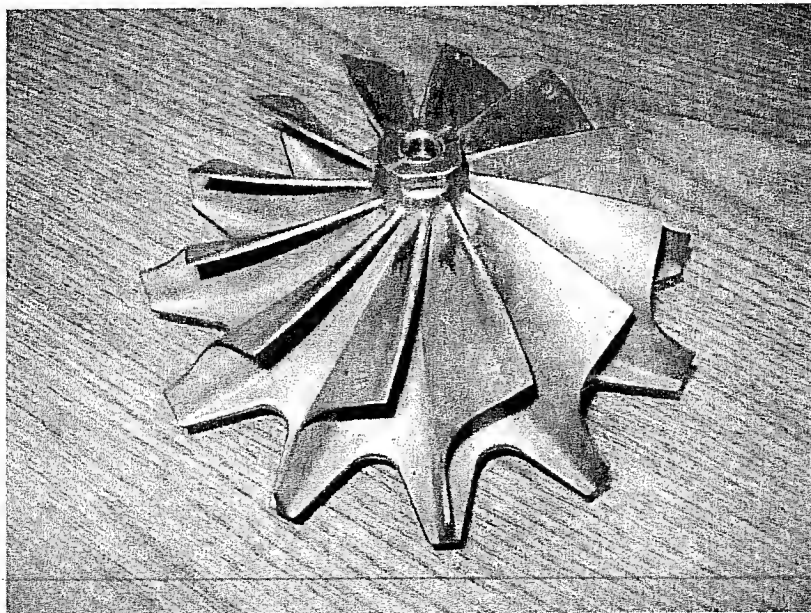


**Figure 10. Compressor Wheel Supplied by Hamilton Sundstrand**

**Cost-Based.** The negotiated unit price of \$3,598 for the turbine engine rotor (NSN 2835-01-310-0117), based on recently supplied cost data, was basically in line with our cost analysis of cost data obtained during a previous audit. Table 16 shows the comparison of prices developed using the Air Force pricing method and cost data from a previous audit.

<b>Table 16. Comparison of Cost-Based Pricing for Turbine Engine Rotor (NSN 2835-01-310-0117)</b>							
	<u>Air Force Contract</u>			<u>OIG Previous Audit</u>		<u>Difference</u>	
	<u>AD</u> <u>Q</u>	<u>Unit</u>	<u>Total</u>	<u>Unit</u>	<u>Total</u>	<u>Amount</u>	<u>Percent</u>
Cost-Based	316	3,598.00	1,136,968	3,570.09	1,128,149	8,819	0.8

Figure 11 shows the turbine engine rotor that is part of the Jet Fuel Starter used on the F-16 aircraft.



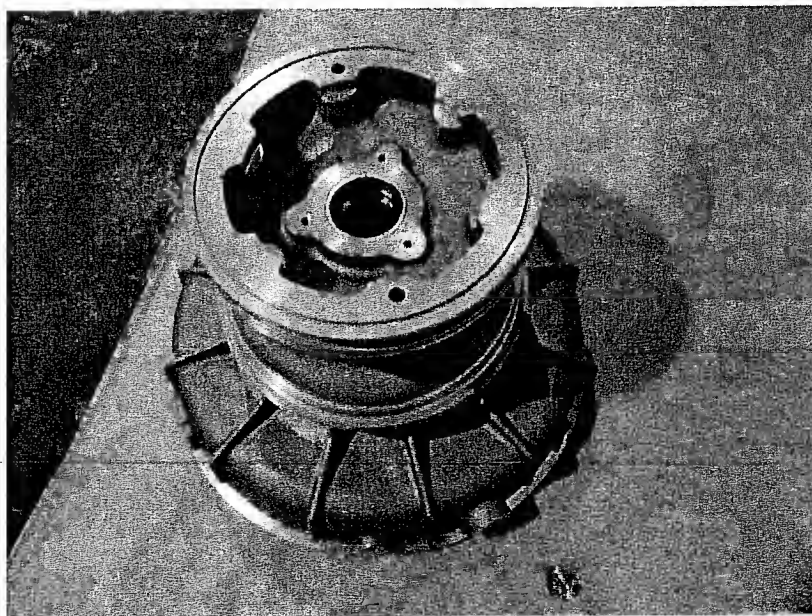
**Figure 11. Rotor for the F-16 Aircraft Turbine Engine**

Similarly, by performing cost analysis, the Air Force negotiating team reduced the unit price of the air inlet housing assembly (NSN 2835-01-056-8593) used on the F-16 aircraft to \$1,933.44 (about 50 percent) from the previous price paid. In January 2004, 93 housing assemblies were purchased from Hamilton Sundstrand's exclusive distributor (AAR Defense Systems) at a unit price of \$4,625.50. After removing the 20 percent burden applied by the distributor, we calculated the unit price paid to Hamilton Sundstrand was \$3,854.58. Table 17 shows the results of the cost analysis performed.

<b>Table 17. Results of Air Force Cost Analysis for Air Inlet Housing Assembly (NSN 2835-01-056-8593)</b>							
	<u>Air Force Contract</u>			<u>Comparison Price</u>		<u>Difference</u>	
	<u>AD</u>	<u>Unit</u>	<u>Total</u>	<u>Unit</u>	<u>Total</u>	<u>Amount</u>	<u>Percent</u>
Cost-Based	37	\$1,933.44	\$71,537	\$3,854.58	\$142,620	(\$71,082)*	(49.8)

\* Slight rounding inconsistencies exist due to auditor calculations based on two decimal places.

Figure 12 shows the air inlet housing assembly used on the F-16 aircraft.



**Figure 12. F-16 Aircraft Air Inlet Housing Assembly**

As shown by the examples discussed above, performing cost analysis is the most effective means to determine price reasonableness.

**Potential Total Contract Impact.** If the strategic sourcing contract used price-based prices for between 60–80 percent of the dollars and the unexplained price increase is roughly 30 percent, the excessive profit paid for the 9-year \$860 million contract would range from approximately \$155 million to \$206 million. Table 18 provides an illustration of the potential impact of overpricing based on the percent of the unexplained increase and the percentage of the contract that uses price analysis. The excessive profit paid for Phase 1 of the contract, which has a 9-year annual demand of about \$147 million, would range from approximately \$26.5 million to \$35.3 million.

<b>Table 18. Potential Overpayment (Risk) Based on Contract Value</b>					
Unexplained Percent Increase	Percent of \$860 Million Contract Value (\$ millions)				
	20	40	60	80	100
100	\$172	\$344	\$516	\$688	\$860
90	155	310	464	619	774
80	138	275	413	550	688
70	120	241	361	482	602
60	103	206	310	413	516
50	86	172	258	344	430
40	69	138	206	275	344
30	52	103	155	206	258
20	34	69	103	138	172
10	17	34	52	69	86
0	0	0	0	0	0

The Air Force also needs to issue guidance that discontinues the use of price analysis to determine price reasonableness unless the validity of the comparison can be established.

**Congressional Guidance.** Due to its concern about commercial item waivers to TINA, Congress included new provisions in the National Defense Authorization Act for Fiscal Year 2003 for cost accounting standards waivers and annual reporting requirements for DoD in cases where a waiver or commercial item exception was granted for contracts valued over \$15 million. Specifically, Section 817 of the Act, “GRANTS OF EXCEPTIONS TO COST OR PRICING DATA CERTIFICATION REQUIREMENTS AND WAIVERS OF COST ACCOUNTING STANDARDS,” requires:

(b) DETERMINATION REQUIRED FOR EXCEPTIONAL CASE EXCEPTION OR WAIVER.—The guidance shall, at a minimum, include a limitation that a grant of an exceptional case exception or waiver is appropriate with respect to a contract, subcontract, or (in the case of submission of certified cost and pricing data) modification only upon a determination that—

(1) the property or services cannot reasonably be obtained under the contract, subcontract, or modification, as the case may be, without the grant of the exception or waiver;

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(2) the price can be determined to be fair and reasonable without the submission of certified cost and pricing data or the application of cost accounting standards, as the case may be; and

(3) there are demonstrated benefits to granting the exception or waiver.

**(d) ANNUAL REPORT ON BOTH COMMERCIAL ITEM AND EXCEPTIONAL CASE EXCEPTIONS AND WAIVERS WITH PRICE OR VALUE GREATER THAN \$15,000,000—(1)** The Secretary of Defense shall transmit to the congressional defense committees promptly after the end of each fiscal year a report on commercial item exceptions, and exceptional case exceptions and waivers, described in paragraph (2) that were granted during that fiscal year.

(2) The report for a fiscal year shall include--

(A) with respect to any commercial item exception granted in the case of a contract, subcontract, or contract or subcontract modification that is expected to have a price of \$15,000,000 or more, an explanation of the basis for the determination that the products or services to be purchased are commercial items, including an identification of the specific steps taken to ensure price reasonableness; and

(B) with respect to any exceptional case exception or waiver granted in the case of a contract or subcontract that is expected to have a value of \$15,000,000 or more, an explanation of the basis for the determination described in subsection (b), including an identification of the specific steps taken to ensure that the price was fair and reasonable. [emphasis added]

The Air Force has not yet reported the strategic sourcing contract as required by the FY 2003 National Defense Authorization Act; however, in our opinion the contract does not have adequate support for the commercial items exception nor does the pricing strategy adequately support price reasonableness determinations. The Assistant Secretary of the Air Force needs to report the required information to the Secretary of Defense for all FAR Part 12 commercial contracts.

## Conclusion

While the Defense weapon systems spare parts procured on the Air Force strategic sourcing FAR Part 12 commercial contract with Hamilton Sundstrand may meet the liberal statutory commercial item definition, the Air Force did not use commercial marketplace pricing to price any of the 1,011 Phase 1 items. Price analysis of previous Government prices was used to price the majority of the items, which was not effective to determine price reasonableness for noncompetitive spare parts.

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## Management Comments on the Finding and Audit Response

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) acknowledged that 24 items were incorrectly priced under the Phase 1 contract award, and have taken appropriate management action to correct the errors. The Military Deputy also stated that the vast majority of the 1,011 items being procured were priced accurately. Our estimates for Air Force savings over the 9-year life of this contract exceed \$2.8 million, with an additional \$18.9 million savings when Defense Logistics Agency (DLA) line items are included.

**Audit Response.** We agree that the 24 items were incorrectly priced under Phase 1 of the contract and that the Air Force needs to obtain cost information from Hamilton Sundstrand to determine fair and reasonable prices for these items. This information will indicate the effectiveness of the Air Force pricing efforts. We disagree, as shown in the report, that the “vast majority of the 1,011 items were priced accurately.” The Air Force pricing strategy relied primarily on the price analysis of questionable previous Government prices and failed to adequately use the commercial marketplace or sufficient cost data when negotiating prices.

Further, the Air Force calculated savings show the difference between the initial proposed prices and negotiated contract prices. While negotiations were successful at achieving lower prices than proposed, the claimed savings have no bearing on whether contract prices were fair and reasonable. The audit report addressed the reasonableness of the negotiated contract prices.

## Recommendations, Management Comments, and Audit Response

On September 28, 2006, the Deputy Assistant Secretary (Contracting), Assistant Secretary (Acquisition) provided technical corrections to the initial Air Force response. Those corrections were incorporated in management comments where appropriate.

### **B.1. We recommend that the Assistant Secretary of the Air Force (Acquisition):**

- a. Initiate action to develop alternate sources for noncompetitive Hamilton Sundstrand items if the contractor fails to satisfy requirements for information other than cost or pricing data described in Recommendation B.2.**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) concurred with the recommendation. The Military Deputy commented that if Hamilton Sundstrand fails to provide adequate information necessary for the contracting officer to make a fair and reasonable price determination, the Assistant Secretary of the Air Force

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(Acquisition) will request Ogden Air Logistics Center to initiate actions to develop alternate sources for the necessary items.

**Audit Response.** We consider the Air Force comments responsive.

**b. Report the basis of commercial items determinations and steps taken to ensure price reasonableness for all Federal Acquisition Regulation Part 12 commercial contracts with an estimated value of \$15 million or more annually to the Secretary of Defense as required by the National Defense Authorization Act of Fiscal Year 2003.**

**Management Comments.** In the technical corrections, the Deputy Assistant Secretary (Contracting) concurred with the recommendation and stated that the Air Force fully intends to comply with existing commercial contract reporting requirements for the Hamilton Sundstrand contract.

**Audit Response.** We consider the Air Force comments responsive.

**c. Provide assistance to the contracting officer and the Director of Contracting, Ogden Air Logistics Center, Hill Air Force Base, Utah, in obtaining cost information for 24 price-based parts from Hamilton Sundstrand.**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) concurred with the recommendation. The Military Deputy commented that if the contracting officer and the Director of Contracting, Ogden Air Logistics Center are unsuccessful in obtaining the requested cost information, the Assistant Secretary of the Air Force (Acquisition) will provide assistance as appropriate.

**Audit Response.** We consider the Air Force comments partially responsive. We have received information that Hamilton Sundstrand has again refused to provide the requested cost data for the 24 price-based parts to Ogden Air Logistics Center. The Air Force has since requested Hamilton Sundstrand to review the "validity of the basis of negotiations," which does not meet the intent of the recommendation. We do not believe the strategic sourcing initiative should proceed until the cost data requested by the Air Force is obtained and reviewed by appropriate DoD audit agencies. The Air Force needs to provide additional comments to the final report as to whether the requested cost data has been obtained.

**B.2. We recommend that the Commander, Ogden Air Logistics Center, Hill Air Force Base, Utah, instruct the contracting officer for the strategic sourcing commercial contract with Hamilton Sundstrand to terminate the current pricing strategy and take the following actions:**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) concurred with the recommendation. The Military Deputy commented that subsequent to the pricing of the Phase 1 items, the Director of Contracting, Ogden Air Logistics Center, instructed the contracting officer not to utilize the existing pricing strategy for the pricing of the Phase 2 and 3 items.

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**Audit Response.** We consider the Air Force comments partially responsive and request that the Air Force provide an explanation of the pricing strategy used in Phases 2 and 3 of the contract.

**a. Require submission of data other than certified cost or pricing data from the contractor that, at a minimum, should include appropriate information on the prices at which the same item or similar items have previously been sold in the commercial market that is adequate for evaluating the reasonableness of the price of the procurement.**

**Management Comments.** In the technical corrections, the Deputy Assistant Secretary (Contracting) partially concurred with the recommendation and stated that the contracting officer is responsible for obtaining adequate information in order to determine a fair and reasonable price. Accordingly in Phases 2 and 3, Hamilton Sundstrand will be required to provide commercial market sales data adequate for evaluating the reasonableness of the price where appropriate, including data on sales for the same or similar items in quantities similar to Air Force and Defense Logistics Agency demand quantity requirements. If the data is not sufficient for determining the price to be fair and reasonable, then the contracting officer will look at data available from other sources in an effort to justify prices offered and verify that sufficient cost or price analysis was performed on the previous price to determine prices fair and reasonable. If the contracting officer cannot obtain adequate information from sources other than the contractor, then the contracting officer will require the contractor to submit information other than cost or pricing data including existing information on the prices at which same or similar items may have been previously sold.

During Phase 1, when the contracting officer determined that adequate information from sources other than the contractor was not available, Hamilton Sundstrand provided past sales information where it existed. In those cases where adequate sales data did not exist, Hamilton Sundstrand provided additional information other than cost or pricing data to support their proposal.

**Audit Response.** We consider the Air Force comments partially responsive. The procedures the Air Force described are the basic pricing procedures identified at FAR 15.402, "Pricing Policy." Finding A of the report, discussed how this guidance has become muddled and disordered in regard to noncompetitive commercial items. The USD(AT&L) has agreed to provide additional guidance in this area.

The audit showed that the Air Force relied primarily on price analysis of previous Government prices that had not been determined fair and reasonable by DLA and on previous audits. As a result, there was not adequate information available within the Government to effectively price the noncompetitive items. In addition, the audit showed that there was not adequate information available from sources other than the offeror and that the offeror did not have adequate commercial sales to effectively or appropriately price the items. Further, Hamilton Sundstrand has repeatedly refused to provide cost data to support price reasonableness when requested. In DoD IG Report No. D-2004-064, "Acquisition of the Boeing KC-767A Aerial Refueling Tanker," March 29, 2004, the Air Force made similar mistakes by not obtaining commercial market sales information or cost data from

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the offeror for the \$23.5 billion program; as a result, we determined that the pricing strategy used was high-risk and the price could be overstated by billions. Therefore, we request the Air Force provide an explanation of how a commercial pricing strategy can be effectively used to price the noncompetitive items in Phases 2 and 3 of the contract.

**b. Incorporate Federal Acquisition Regulation 52-215.20(ii), “Commercial Item Exception,” in the contract.**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) partially concurred with the recommendation. The Military Deputy commented that in accordance with FAR 15.408(l), the contracting officer may insert the provision at 52.215-20 in solicitations where it is reasonably expected that cost or pricing data or information other than cost or pricing data may be required. The Military Deputy commented that Alternate IV shall be considered if an exception to cost or pricing data submission exists and submission of information other than cost or pricing data will be required. The Military Deputy also commented that FAR 52.215-20 is a solicitation provision, not a contract provision. The Hamilton Sundstrand solicitation did include the provision at FAR 52.215-20 and Alternate IV. Additionally, any future solicitations associated with this contract will include the provision at FAR 52.215-20 and Alternate IV as applicable.

**Audit Response.** We consider the Air Force comments nonresponsive. We recognize that the solicitation included Alternate IV of the FAR 52.215-20 provision. The Air Force replaced the basic requirements of the exception provision for obtaining cost or pricing data, which required “at a minimum, information on prices at which the same item or similar items have been sold in the commercial market that is adequate for evaluating the reasonableness of price” with the high-risk Phase 1 pricing strategy. The Director of Contracting, Ogden Air Logistics Center has instructed the contracting officer not to utilize that pricing strategy for future phases of the contract and our audit report found that the strategy was not effective in obtaining fair and reasonable prices. Further, the 63 Phase 1 items priced under the “catalog” or commercial marketplace scenario were not priced based on commercial market sales and accounted for only 1.3 percent of the total Phase 1 annual contract value of \$19.6 million. As a result, the Air Force has no basis to grant a commercial item exception to cost or pricing data for this contract. If the contractor does not have sufficient commercial sales to support price reasonableness, the exception to cost or pricing data should not be granted. The Air Force needs to describe the basis for granting a commercial item exception to cost or pricing for Phase 2 and 3 items in its comments to the final report.

**c. Limit requests for information from the contractor on commercial sales to quantities similar to DoD annual demand quantities.**

**Management Comments.** In the technical corrections, the Deputy Assistant Secretary (Contracting) concurred with the recommendation and stated that commercial market sales information for the same or similar to items should be obtained in quantities similar to DoD annual demand quantities to ensure a suitable comparison for establishing prices.

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**Audit Response.** We consider the Air Force comments responsive.

**d. Make a determination that any “of a type” items meeting the requirements in Recommendation B.2.a. are sufficiently similar to the military item and any difference in price can be identified and justified. Any significant difference in similarity or price should be supported by cost analysis.**

**Management Comments.** In the technical corrections, the Deputy Assistant Secretary (Contracting) partially concurred with the recommendation and stated the Air Force will assess “of a type” commercial items considered for Phases 2 and 3 of the contract and ensure adequate similarity to the military item. The Air Force will also support any significant price difference between the military and commercial “of a type” items in accordance with existing FAR provisions prescribed for cost and price analysis. If commercial sales of the “of a type” item are not sufficient to determine price reasonableness, information other than cost or pricing data will be requested. Cost analysis will be conducted during pricing efforts when other methods of supporting the pricing efforts are unsuccessful.

**Audit Response.** We consider the Air Force comments responsive.

**e. Make a determination as to whether commercial sales information provided by the contractor is adequate to support a price reasonableness determination.**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) concurred with the recommendation. The Military Deputy commented that it is inherent in the contracting officer’s price reasonableness determination that adequate information was obtained to support the determination. If the contracting officer cannot obtain adequate information from sources other than the offeror, the contracting officer must require submission of information other than cost or pricing data from the offeror that is adequate to determine a fair and reasonable price. This information must include existing information on the prices at which the same or similar items have been previously been sold. If sales data is inadequate or does not exist, the contracting officer must request additional information other than cost or pricing data. The Military Deputy also commented that by definition, if the contracting officer has determined a price to be fair and reasonable and this determination is based on sales data, then the sales data was adequate to support the determination. The requirement is to ensure appropriate cost or pricing techniques are executed to make sure the price is fair and reasonable. This is the process utilized in pricing the instant Hamilton Sundstrand contract.

**Audit Response.** We consider the Air Force comments nonresponsive. The Air Force failed to make a determination that commercial sales information was adequate to support price reasonableness. As discussed in the report, the commercial market sales data provided by Hamilton Sundstrand was inadequate to support a fair and reasonable price justification because commercial market sales were only identified for a small percentage of items and the quantities were not similar to the DoD annual demand requirements. As shown in the report, only 63 items or 1.3 percent of the Phase 1 annual contract demand was categorized as

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“catalog” or commercial marketplace items. We are troubled that the Air Force assumes that if a contracting officer determines the price of a spare part placed on a commercial contract as fair and reasonable, then the commercial sales data submitted by the offeror was adequate. We believe the Air Force lacks an effective method to price commercial items. When procuring noncompetitive commercial items, the offeror is the logical source for information to support price reasonableness. The Air Force needs to make a determination as to whether the contractor has adequate commercial market sales information to support price reasonableness determinations and the exception to cost or pricing data in its comments to the final report.

**f. Require “information other than cost or pricing data” from the contractor which includes cost information when the contracting officer makes a determination that commercial sales information is not adequate to support price reasonableness.**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) partially concurred with the recommendation. The Military Deputy commented that if the contracting officer cannot obtain adequate information from sources other than the contractor, the contracting officer must require contractor submission of information other than cost or pricing data. Information other than cost or pricing data is any type of information that is necessary to determine price reasonableness. Sales history information, including previous sales to the Government, is one form of information other than cost or pricing data. The Military Deputy also commented that if sales history is not sufficient to perform an adequate price analysis, the contracting officer is required to request additional information other than cost or pricing data. The additional information other than cost or pricing data may include cost information if deemed necessary by the contracting officer to determine price reasonableness. This hierarchy was used in pricing the Hamilton Sundstrand contract.

**Audit Response.** We consider the Air Force comments nonresponsive. The Air Force inappropriately used price analysis of previous Government sales to determine price reasonableness for the majority of parts on contract. Price analysis of commercial market sales should be used to determine fair and reasonable prices for commercial items. When the commercial market sales information is not adequate, the Air Force must require information other than cost or pricing data to include cost information to establish price reasonableness. The Air Force has requested cost information for 24 Phase 1 items and Hamilton Sundstrand has refused to provide the information. Phases 2 and 3 of the contract should not proceed until this issue is resolved. Also, see the audit response to Recommendation B.2.a.

**g. Perform price analysis of commercial sales, when sales of the same or similar item previously sold in the commercial market are adequate for evaluating, through price analysis, the reasonableness of price and ensure the integrity of commercial sales information.**

**Management Comments.** In the technical corrections, the Deputy Assistant Secretary (Contracting) concurred with the recommendation and stated that when

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adequate and relevant sales data is available, the contracting officer will utilize this information during Phases 2 and 3 to ensure integrity of commercial sales information and perform price analysis in support of price reasonableness determinations.

**Audit Response.** We consider the Air Force comments responsive.

**h. Perform cost analysis of uncertified cost or pricing data if commercial sales are not adequate to determine price reasonableness. Price analysis of the previous Government price is acceptable if recent cost analysis or competition was used to support the price and there have been no known changes in the manufacturing process that could significantly impact the contractor's costs.**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) concurred with the recommendation. The Military Deputy commented that if the contracting officer cannot obtain adequate information from sources other than the contractor, the contracting officer must require contractor submission of information other than cost or pricing data. This information must include existing information on the prices at which the same or similar items have been previously been sold. If adequate sales data does not exist, the contracting officer must request additional information other than cost or pricing data, which may include cost data. When cost data is received, a cost analysis is performed by the contracting officer. The requirement is to ensure appropriate cost or pricing techniques are executed to make sure the price is fair and reasonable, which was done on this contract. The Military Deputy also commented that in the Hamilton Sundstrand contract, when the contracting officer determined that adequate information from sources other than the contractor was not available, Hamilton Sundstrand provided past sales information where it existed. Further, in those cases where adequate sales data did not exist, Hamilton Sundstrand provided additional information other than cost or pricing data to support its proposal. When this additional information included cost data, a cost analysis was performed.

**Audit Response.** We consider the Air Force comments nonresponsive. When commercial market sales data is inadequate, the Air Force needs to obtain uncertified cost data to establish price reasonableness. While we recognize the difficulty of obtaining cost information from Hamilton Sundstrand, the agreed-upon pricing methodology used in Phase 1 of the contract failed to require this information. The Air Force needs to require that Hamilton Sundstrand provide cost information when commercial sales are inadequate in future phases of the contract. As previously stated Phases 2 and 3 of the contract should not proceed until Hamilton Sundstrand provides cost data for the 24 Phase 1 items as requested by the Air Force and the data is reviewed by appropriate DoD audit agencies. The Air Force needs to provide additional comments to the final report.

**i. Address economic order quantities on any vendor quotes for purchased parts.**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) concurred with the recommendation.

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The Military Deputy commented that economic order quantity information can have a significant impact on final negotiated prices. The Military Deputy also commented that the Phase 1 negotiated prices did consider quantity price sensitivity compared to estimated requirements. As expected, some items were more quantity sensitive than others. As time has proceeded, some quantity estimates have been more accurate than others, thus potentially affecting quantity discounts. The Military Deputy also commented that Hamilton Sundstrand will be requested to provide this information as appropriate to support the applicable Phase 2 and 3 negotiated prices.

**Audit Response.** We consider the Air Force comments nonresponsive. Based on our review of items, the Air Force failed to address economical order quantities for numerous items and the proposed quantities were not representative of actual demand. For example, when a quote is requested for a quantity range of 1-30, that quote is based on the price to manufacture only 1 item. The Air Force should obtain quotes that consider economic quantities. The Air Force needs to provide additional comments to the final report.

**j. Discontinue pricing items with no forecasted or historical demand until an actual requirement exists.**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) partially concurred with the recommendation. The Military Deputy commented that generally, pricing of items with no forecasted or historical demand may not yield results that are reflective of actual pricing for such items at the time of demand, so should be done only in cases where the Government is reasonably certain the benefit will outweigh the time and effort involved. For the items in question, this was a conscious decision made during the acquisition planning phase of this effort. The Military Deputy also commented that in order to reduce lead times for potential items that may be needed to support the warfighter, there were items included in the contract that did not have any historical or forecasted demand. The additional burden associated with adding these items now was insignificant compared to the time and effort that would be required to procure these items after the critical need was identified.

**Audit Response.** We consider the Air Force comments nonresponsive. The Air Force should price parts with known requirements on a long-term contract. Pricing parts on a long-term contract that have never been purchased is high-risk because no relevant historical data exists to establish prices and will only result in a best guess or estimate when negotiating prices. A lower-risk approach is to buy these items on individual contracts and once adequate data exists, then to price the part on a long-term contract. The Air Force needs to provide additional comments to the final report.

**k. Request the Defense Contract Management Agency, Windsor Locks, Connecticut:**

**1. Validate negotiated Phase 1 prices for purchased parts to determine cost realism of vendor quotes that did not address economic order quantities and adjust contract prices if necessary.**

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**2. Review contractor “estimated cost information” for the accessory drive gearbox housing for the F-16 turbine engine (national stock number 2835-01-208-4430) in the next year or two if demand increases as planned and adjust the contract price if necessary.**

**3. Review contractor “estimated cost information” for items manufactured in Puerto Rico after manufacturing standards have been audited and adjust contract prices if necessary.**

**4. Review cost information requested by the Director of Contracting, Ogden Air Logistics Center, Hill Air Force Base, Utah, for 24 price-based parts to substantiate the negotiated prices and adjust contract prices if necessary.**

**Management Comments.** In the technical corrections, the Deputy Assistant Secretary (Contracting) concurred with the recommendation and stated that the contracting officer will pursue completion of the various recommended reviews by Defense Contract Management Agency, Windsor Locks, Connecticut, and will provide status regarding the reviews by January 31, 2007. If indications surface that reveal inflated contract prices as the various reviews are completed, the contracting officer will request that Hamilton Sundstrand mutually agree to a price reduction. If Hamilton Sundstrand is unwilling to agree to a price reduction, the contracting officer may take several actions including elevating the issue to higher Air Force management levels, initiating action to obtain an alternate source, and consider whether a contract termination for convenience is in the government’s best interests.

**Audit Response.** We consider the Air Force comments partially responsive. As of the date of this report, Hamilton Sundstrand has refused to provide cost information for the 24 items requested by the Air Force. The Air Force needs to obtain cost information from Hamilton Sundstrand as part of these “various reviews” as requested to effectively make a determination on the extent of inflated contract prices. Phase 2 and 3 of the contract should not proceed until this issue is resolved. The Air Force needs to provide additional comments to the final report as to whether the requested cost data was obtained.

**1. Determine whether Hamilton Sundstrand should receive a Red (unsatisfactory) out-of-cycle Contractor Performance Assessment Reporting System report rating in “Business Relations,” if the contractor behavior continues to be unreasonable or uncooperative in meeting any of the data requests outlined in the previous recommendations.**

**Management Comments.** The Military Deputy, Office of the Assistant Secretary of the Air Force (Acquisition) concurred with the recommendation. The Military Deputy commented that if it is determined that Hamilton Sundstrand is unreasonable or uncooperative with regards to providing data that is required by regulation and statute and necessary for the contracting officer to determine a fair and reasonable price, an unsatisfactory (red) rating for the “Business Relations” category of its CPARS evaluation will be considered.

**Audit Response.** We consider the Air Force comments responsive.

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## Appendix A. Scope and Methodology

We visited or contacted individuals within the Air Force, DLA, DCAA, and DCMA. We reviewed contract FA8208-05-D-0004 and documentation including modifications, the price negotiation memorandum, and the pricing methodology. We also reviewed commercial item determinations, information other than cost or pricing data, and sales histories. We reviewed Hamilton Sundstrand restructuring actions since 1995. We also performed cost analysis of cost data obtained from a prior audit report. We reviewed procurement histories, a previous corporate contract (SP0700-00-D-9713), and price reasonableness codes for 109 DLA-managed items to establish the reliability of the prior prices used as the basis for price analysis. We reviewed the DLA/Honeywell build-to-order and catalog contract prices and memorandums of agreement. We reviewed Air Force demand information from the D200 system. We separated the items we reviewed into different pricing categories based on the information provided by the DSCR cost analyst. We also reviewed the RAND Corporation 2005 report on price-based acquisition.

**Part Selection.** A total of 1,011 items (52 Air Force and 959 DLA) were priced on Phase 1 of the Hamilton Sundstrand contract with an annual price of about \$16.8 million.<sup>1</sup> We selected 161 high-dollar items (52 Air Force and 109 DLA) with an annual demand of about \$15.7 million (93.3 percent). The DLA/Honeywell build-to-order and catalog contracts had 4,743 items on contract with an annual demand of about \$94.2 million based on the Standard Automated Material Management System acquisition cost and eight-quarter requisition history (April 2003–March 2005). We selected 450 high-dollar items that had an annual demand of about \$61.2 million<sup>2</sup> (65.0 percent).

**Hamilton Sundstrand Scope of Review.** In our demand calculations, we used the average annual requisitions (rounded) obtained from the DLA databases for the 410 DLA items with historical demand and the contract demand for the 52 Air Force and 549 DLA items without any historical demand (rounded to the nearest whole number). To calculate the annual price, we multiplied the ADQ and the Air Force contract price that corresponded to the ADQ. The 1,011 Phase 1 items had an annual price of \$19.6 million; the 462 items with historical demand had an annual price of \$16.3 million, and the 161 items we reviewed had an annual price of \$15.0 million. However, 29 of the 161 items selected were removed from the price comparisons because no comparable previous contract or demand existed.

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<sup>1</sup> The 52 Air Force items had an annual price of about \$3.1 million based on contract demand and contract prices. The 959 DLA items had an annual price of more than \$13.7 million calculated from the acquisition unit cost and annualized eight-quarter requisition history provided by the Standard Automated Material Management System (April 2003–March 2005) and Business System Modernization (July 2003–June 2005) databases. The difference between the calculated annual price and the annual price of \$19.6 million used throughout the remainder of the report is that demand quantities did not exist for 549 items and the acquisition unit cost was used in calculations instead of the contract price.

<sup>2</sup> The difference between this calculated annual price and the annual price of \$53.3 million used in Table 11 of the report is due to the fact that the demand quantities were not rounded up to the next whole number and the acquisition unit cost provided by Standard Automated Material Management System database was used in the calculations instead of the DLA/Honeywell contract unit price.

As a result, our review focused on 132 items with an annual price of \$12.7 million or 77.5 percent of the annual demand dollars for items with historical demand. For the 132 items we reviewed, we performed price comparisons of pre-FASA contract prices for 129 items and cost analysis for 3 items. Table A-1 below shows the dollars for the Air Force contract and OIG audit coverage.

<b>Table A-1. Demand for Air Force Contract and OIG Coverage</b>						
<u>Scenario</u>	<u>Air Force Contract</u>			<u>OIG Reviewed</u>		
	<u>Items</u>	<u>Total Price<sup>1</sup></u>	<u>Percent</u>	<u>Items</u>	<u>Total Price<sup>1</sup></u>	<u>Percent</u>
1. Catalog	0	0	0.0	0	0	0.0
2. Cost-Based						
Purchased	510	\$ 1,943,115	9.9	21	\$ 696,909	35.9
Manufactured	<u>184</u>	<u>6,008,495</u>	<u>30.6</u>	<u>16</u>	<u>3,407,654</u>	56.7
Cost-Based Subtotal	694	7,951,610	40.5	37 <sup>2</sup>	4,104,563	51.6
3. Price Analysis						
Price-Based	254	11,415,845	58.2	93	8,381,601	73.4
Catalog	<u>63</u>	<u>259,139</u>	<u>1.3</u>	<u>2</u>	<u>181,359</u>	70.0
Price Analysis Subtotal	317	11,674,984	59.5	95 <sup>3</sup>	8,562,960	73.3
<b>Total</b>	<b>1,011</b>	<b>\$19,626,595<sup>4</sup></b>	<b>100.0</b>	<b>132</b>	<b>\$12,667,523</b>	<b>64.5</b>
<b>Total (Demand Items)</b>	<b>462</b>	<b>\$16,338,751</b>	<b>100.0</b>	<b>132</b>	<b>\$12,667,523</b>	<b>77.5</b>

<sup>1</sup>Calculated by multiplying the ADQ and the Air Force contract price that corresponded to the ADQ.

<sup>2</sup>Represents the 36 cost-based items shown in Table 5 and 1 San Diego item shown in Table 13.

<sup>3</sup>Represents the 93 price-based items, including 2 items categorized as catalog, shown in Table 10 and 2 San Diego items shown in Table 13.

<sup>4</sup>Slight rounding inconsistencies exist due to auditor calculations based on two decimal places.

**Price Comparison.** We compared contract prices from before the enactment of FASA to prices on the Hamilton Sundstrand and Honeywell contracts.<sup>3</sup> We selected the most recent contract awarded after May 31, 1985, but before October 13, 1994 (the enactment date for FASA), from procurement histories printed from Information Handling Service Haystacks Gold database. We selected the contract awarded closest to the FASA enactment date for items that did not have any contracts that met the above criteria. However, 32 of the 161 items from the Hamilton Sundstrand and 18 of the 450 items from the Honeywell strategic supplier alliance were not included in our analysis because the items had no valid comparison contract or were covered by performing cost analysis. As a result, our price analysis of the 2 strategies focused on 129 Hamilton Sundstrand items and 432 Honeywell items. We inflated the prices used in our analysis to 2005 dollars by applying the Bureau of Labor Statistics Producer Price Index for Aircraft Engines and Engine Parts midpoint factors.

<sup>3</sup> The Honeywell catalog contract has a management fee included in the negotiated contract prices. We removed the management fee from these prices before using them in our analysis.

**Follow-Up on DoD Inspector General Report No. 98-064, “Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111.”** In the February 6, 1998, report, we calculated, using cost analysis, that DLA could save \$21.3 million during calendar years 1998 through 2003 by paying fair and reasonable prices for commercial items. In response to the audit, DLA took aggressive action and awarded an indefinite-delivery corporate contract to Hamilton Sundstrand for 216 sole-source items, with estimated 6-year savings of \$83.8 million.

For 35 commercial items, we calculated that cost-based prices would have been 73.2 percent less than the market-based prices. The most recent contract prices for these items show that DLA is currently paying 67 percent less than the original market-based prices (adjusted for inflation). Therefore, DLA was successful in negotiating lower prices for these commercial items, which resulted in about \$3.4 million in recurring annual savings.<sup>4</sup>

For 39 noncommercial items, we calculated that cost-based prices would have been 27.5 percent less than the negotiated prices. The most recent contract prices for these items show that DLA was also successful in negotiating lower prices for these items, and is currently paying 12.7 percent less than the original negotiated prices (adjusted for inflation) and obtaining annual recurring savings of \$326,643.

Table A-2 shows that the annual recurring savings for these 74 items is more than \$3.7 million.

	DoD Inspector General Report 98-064			Audit Followup		
	Prior Prices	Cost-Based	Percent Difference	Current Prices	Percent Difference	Annual Savings
Commercial	\$5,020,638	\$1,345,473	73.2	\$1,628,089	67.6	\$3,392,549
Noncommercial	<u>2,579,010</u>	<u>1,870,347</u>	27.5	<u>2,252,367</u>	12.7	<u>326,643</u>
<b>Total</b>	<b>\$7,599,648</b>	<b>\$3,215,820</b>	<b>57.7</b>	<b>\$3,880,456</b>	<b>48.9</b>	<b>\$3,719,192</b>

We performed this audit from June 2005 through May 2006 in accordance with generally accepted government auditing standards.

**Reliability of Computer-Processed Data.** To perform the work, we relied on computer-processed data from DLA, Hamilton Sundstrand, and commercial sources. We obtained Standard Automated Material Management System and Business System Modernization data from DSCR or the Defense Operations Resource and Research Analysis Office to include demand, pricing, and inventory information (as of November 2005) for DLA items. However, we did not receive

<sup>4</sup> Calculations of annual savings were based on annualized eight-quarter requisitions (January 2004 – December 2005) from the Standard Automated Material Management System and Business System Modernization databases.

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any data for eight items. In addition, 541 items did not have historical demand/requisition history within the last eight quarters (2003–2005). We reviewed information other than cost or pricing data from the Hamilton Sundstrand accounting system. We discussed the cost information and system reliability with DCAA and DCMA officials at the Hamilton Sundstrand, Windsor Locks, Connecticut, office. We also reviewed recent DCAA reports, which found that the cost accounting system used by Hamilton Sundstrand was working appropriately. We printed procurement histories from Information Handling Service Haystacks Gold database. However, due to Freedom of Information Act exceptions, the Air Force does not provide contract unit prices to Haystacks; we obtained this information from the Air Force contracting officer. The computer-processed data obtained from DLA and Haystacks were determined reliable, based on a comparison of unit prices and dates to source documents such as contract documentation and delivery orders. In addition, we have used procurement histories from Information Handling Service Haystacks Gold for the past several audits and have not found any material errors or discrepancies. We did not find errors that would preclude the use of the computer-processed data to meet the audit objectives or that would change the conclusions reached in the report.

**GAO High-Risk Areas.** GAO has identified several high-risk areas in DoD. This report provides coverage of the Defense Contract Management and Defense Supply Chain Management high-risk areas.

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## Appendix B. Prior Coverage

During the last 9 years, the GAO and the DoD Inspector General (IG) have issued 27 reports discussing commercial and noncommercial prices of weapon systems and spare parts. Unrestricted GAO reports can be accessed over the Internet at <http://www.gao.gov>. Unrestricted DoD IG reports can be accessed at <http://www.dodig.mil/audit/reports>. Dates in parenthesis indicate redacted versions.

### GAO

GAO Report No. GAO-05-169, "Contract Management: The Air Force Should Improve How It Purchases AWACS Spare Parts," February 15, 2005

GAO Report No. GAO-02-565, "Defense Acquisitions: Navy Needs Plan to Address Rising Prices in Aviation Parts," May 31, 2002

GAO Report No. GAO-02-452, "Defense Inventory: Trends in Services' Spare Parts Purchased from the Defense Logistics Agency," April 30, 2002

GAO Report No. GAO-02-505, "Defense Acquisitions: Status of Defense Logistics Agency's Efforts to Address Spare Part Price Increases," April 8, 2002

GAO Report No. GAO-01-244, "Performance and Accountability Series: Major Management Challenges and Program Risks, Department of Defense," January 1, 2001

GAO Report No. GAO-01-23, "Defense Acquisitions: Prices of Navy Aviation Spare Parts Have Increased," November 6, 2000

GAO Report No. GAO-01-22 (OSD Case No. 2080), "Defense Acquisitions: Price Trends for Defense Logistics Agency's Weapon Systems Parts," November 3, 2000

GAO Report No. NSIAD-00-123, "Defense Acquisitions: Prices of Marine Corps Spare Parts Have Increased," July 31, 2000

GAO Report No. NSIAD-00-30 (OSD Case No. 1920), "Defense Inventory: Opportunities Exist to Expand the Use of Defense Logistics Agency Best Practices," January 26, 2000

GAO Report No. NSIAD-00-22 (OSD Case No. 1903), "Contract Management: A Comparison of DoD and Commercial Airline Purchasing Practices," November 29, 1999

GAO Report No. NSIAD-99-90 (OSD Case No. 1808), "Contract Management: DoD Pricing of Commercial Items Needs Continued Emphasis," June 24, 1999

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## **DoD IG**

DoD IG Report No. D-2006-055, "Spare Parts Procurements From TransDigm, Inc.," February 23, 2006

DoD IG Report No. D-2004-064, "Acquisition of the Boeing KC-767A Tanker Aircraft," March 29, 2004

DoD IG Report No. D-2004-012, "Sole-Source Spare Parts Procured From an Exclusive Distributor," October 16, 2003

DoD IG Report No. D-2002-112, "Industrial Prime Vendor Program at the Air Force Air Logistics Centers," June 20, 2002

DoD IG Report No. D-2002-059, "Results of the Defense Logistics Agency Strategic Supplier Alliance with Honeywell International, Incorporated," March 13, 2002

DoD IG Report No. D-2001-171, "Industrial Prime Vendor Program at the Naval Aviation Depot – Cherry Point," August 6, 2001

DoD IG Report No. D-2001-072, "Industrial Prime Vendor Program at the Naval Aviation Depot – North Island," March 5, 2001

DoD IG Report No. D-2001-001, "Contract Award for the Fluid Flow Restrictor Spare Part," October 3, 2000

DoD IG Report No. D-2000-192, "Results of the Defense Logistics Agency Strategic Supplier Alliance for Catalog Items," September 26, 2000

DoD IG Report No. D-2000-099, "Procurement of the Propeller Blade Heaters for the C-130 and P-3 Aircraft," March 8, 2000 (June 12, 2000)

DoD IG Report No. D-2000-098, "Spare Parts and Logistics Support Procured on a Virtual Prime Vendor Contract" March 8, 2000 (June 14, 2000)

DoD IG Report No. 99-218, "Sole-Source Noncommercial Spare Parts Orders on a Basic Ordering Agreement," July 27, 1999 (October 12, 1999)

DoD IG Report No. 99-217, "Sole-Source Commercial Spare Parts Procured on a Requirements Type Contract," July 21, 1999 (August 16, 1999)

DoD IG Report No. 99-026, "Commercial Spare Parts Purchased on a Corporate Contract," October 30, 1998 (January 13, 1999)

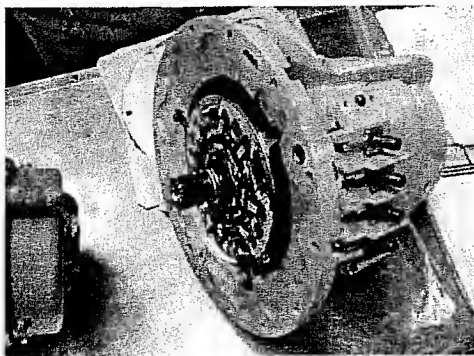
DoD IG Report No. 98-088, "Sole-Source Prices for Commercial Catalog and Noncommercial Spare Parts," March 11, 1998 (October 13, 1998)

DoD IG Report No. 98-064, "Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-M111," February 6, 1998 (June 24, 1998)

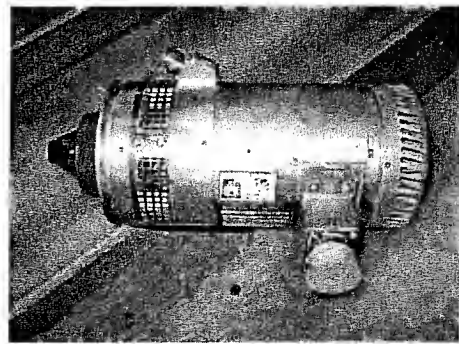
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## Appendix C. Pricing Issues for Generators and Generator Components

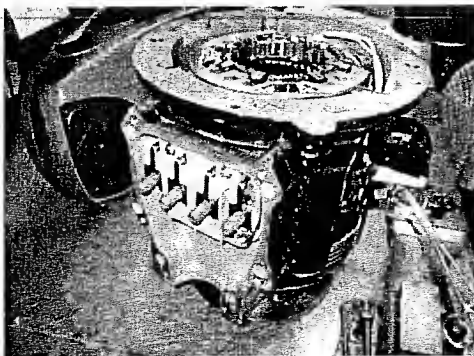
**Generator Prices.** A significant number of items included on Phase 1 of the strategic sourcing contract were generators and component parts used on generators of various military aircraft. We specifically reviewed generators used on the F-16, E-3, and B-1B aircraft that had a combined annual price of more than \$1.2 million. Even though these generators for the various aircraft appear similar, perform similar functions, and use similar components, the prices are significantly different; as a result, contracting officers are not able to rely only on the prices of similar items to negotiate fair and reasonable prices for these items. For example, the prices for these four generators vary in price by 68 percent, from \$22,928.41 to \$38,535.79, despite the prices being based on Hamilton Sundstrand cost data. The figures below show the generators we reviewed.



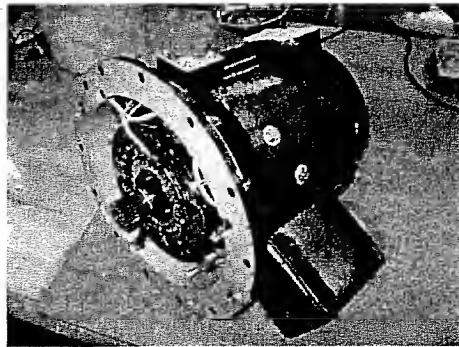
**Figure C-1. F-16 Generator**  
NSN 6115-01-236-8434  
Unit Price \$23,007.12 – ADQ 21  
Annual Price \$483,150



**Figure C-2. F-16**  
NSN 6115-01-246-5622  
Unit Price \$22,928.41 – ADQ 4  
Annual Price \$91,714



**Figure C-3. E-3 Generator**  
NSN 6115-01-104-8632  
Unit Price \$30,857.14 – ADQ 7

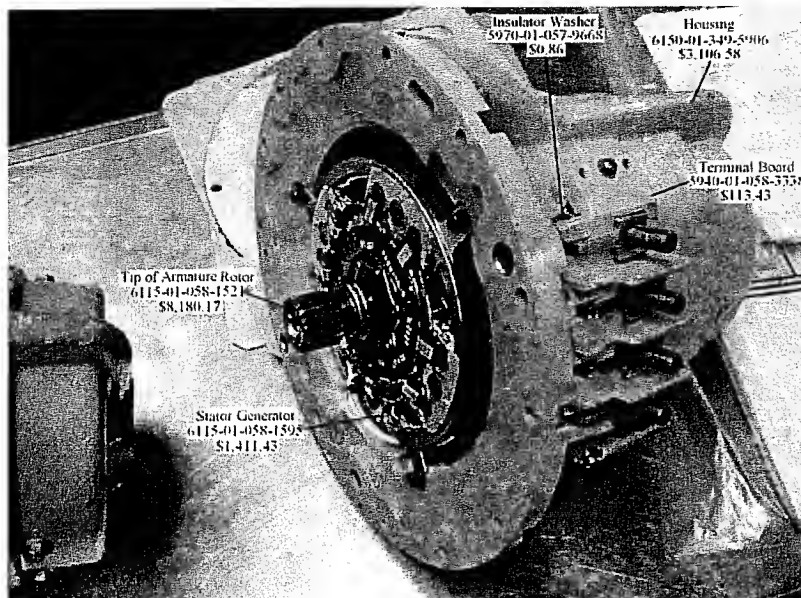


**Figure C-4. B-1B Generator**  
NSN 6115-01-149-7588  
Unit Price \$38,535.79 – ADQ 11

**Annual Price \$216,000**

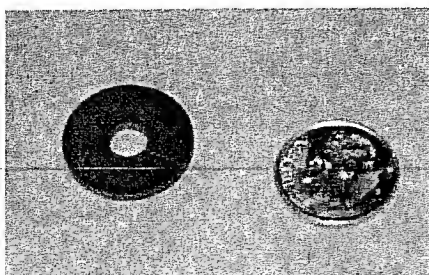
**Annual Price \$423,894**

**Generator Overview.** The main components of a generator generally include the housing, stator, armature rotor, and terminal board. Figure C-1 (enlarged) below is a picture of the F-16 generator and these components.

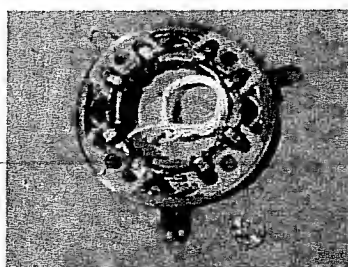


**Figure C-1 (enlarged). F-16 Generator**

The figures below show detailed pictures of the insulator washer and stator generator illustrated in Figure C-1 (enlarged), the pricing methodology, and the annual price.

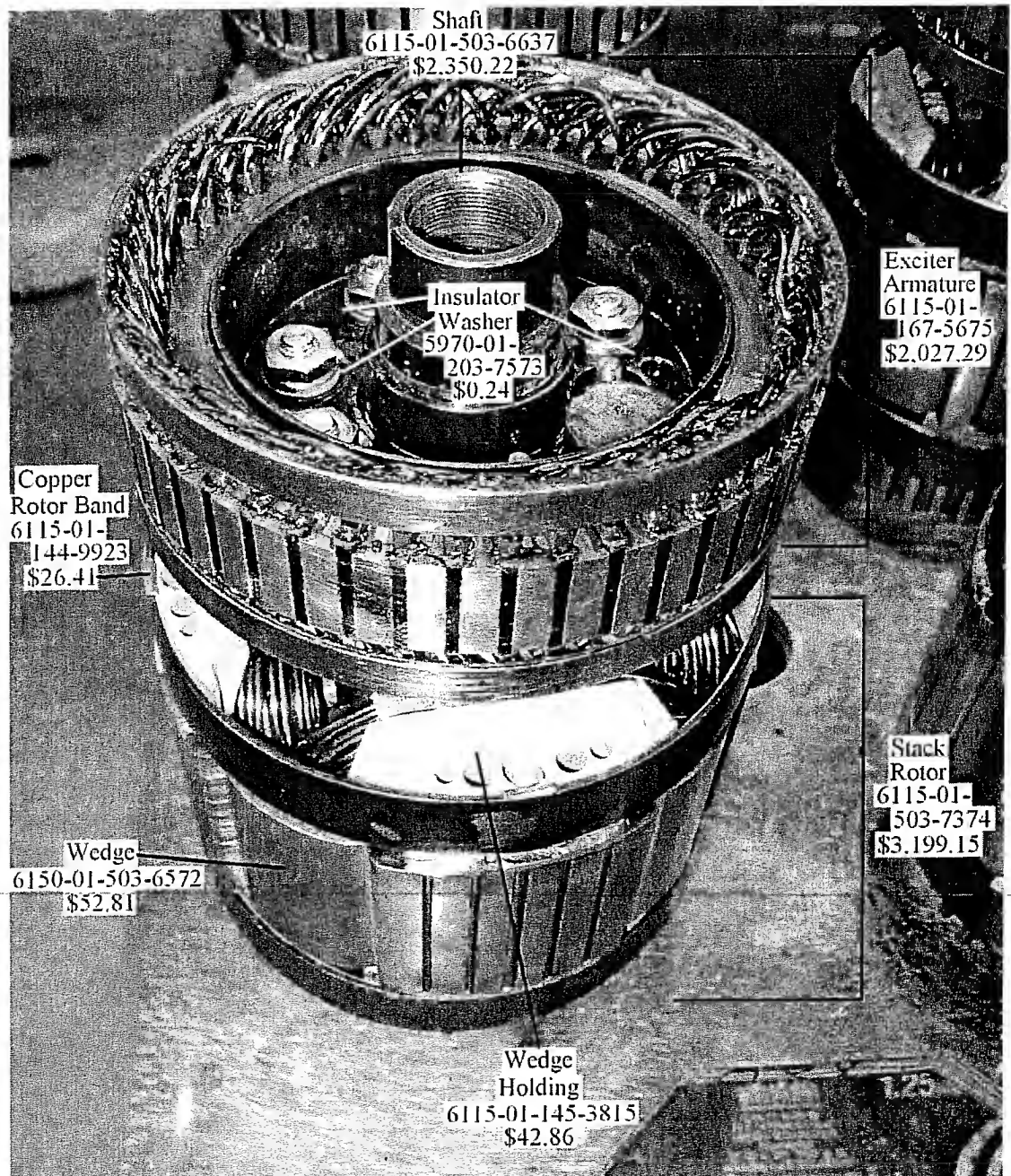


**Figure C-1.a. Insulator Washer**  
NSN 5970-01-057-9668  
Vendor quote  
Unit Price \$0.86 – ADQ 597  
Annual Price \$513



**Figure C-1.b. Stator Generator**  
NSN 6115-01-058-1595  
Price-based  
Unit Price \$1,411.43 – ADQ 272  
Annual Price \$383,908

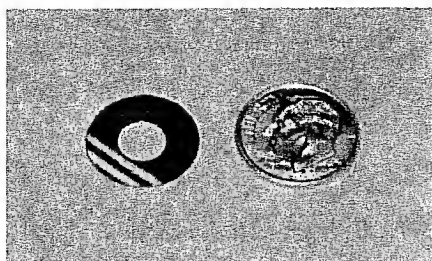
The three main components of the armature rotor are the shaft, exciter armature, and stack rotor. Figure C-1.c below is a detailed picture of the armature rotor for the F-16 generator and component parts we reviewed.



**Figure C-1.c. Armature Rotor for the F-16 Generator**  
**NSN 6115-01-058-1521**  
**Unit Price \$8,170.17 – ADQ 5**  
**Annual Price \$40,901**

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The components on the armature rotor that we reviewed include an insulator washer, copper rotor band, wedge holding, and wedge. The figures below show these components, the pricing methodology, and annual price.

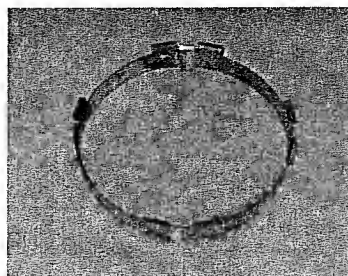


**Figure C-1.c.1. Insulator Washer**  
NSN 5970-01-203-7573

**Vendor quote**

**Unit Price \$0.24 – ADQ 19,004**

**Annual Price \$4,561**

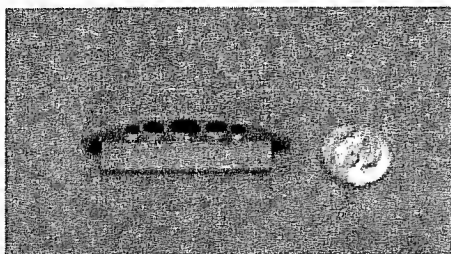


**Figure C-1.c.2. Copper Rotor Band**  
NSN 6115-01-144-9923

**Price-based**

**Unit Price \$26.41 – ADQ 1,143**

**Annual Price \$30,191**

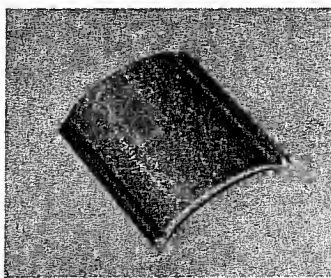


**Figure C-1.c.3. Wedge Holding**  
NSN 6115-01-145-3815

**Cost-based manufactured**

**Unit Price \$42.86 – ADQ 3,030**

**Annual Price \$129,866**



**Figure C-1.c.4. Wedge**  
NSN 6150-01-503-6572

**Vendor quote**

**Unit Price \$52.81 – ADQ 868**

**Annual Price \$45,836**

**Component Prices.** We found significant price variations similar to what we found with the generators when we compared generator component parts, such as terminal boards and wedges, for the different military aircraft. Again, the contracting officers did not have a substantial basis to determine the cost of the item.

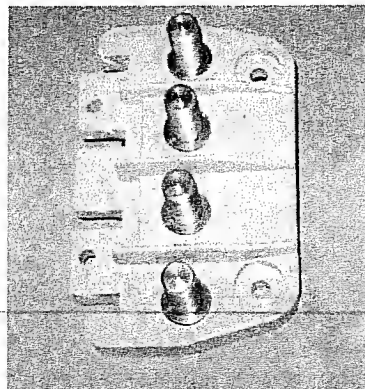
**Terminal Boards.** We compared six terminal boards with historical or forecasted demand priced on Phase 1 of the strategic sourcing contract that had a combined annual price of \$148,645. Price analysis was used to price five of the six terminal boards and a vendor quote was used to price the remaining one. As discussed previously in finding B of the report, price analysis is not effective and the vendor quotes Hamilton Sundstrand provided did not always contain economical quantity ranges. Because the methods used to negotiate prices for the terminal boards failed to provide insight of actual costs, the contracting officials do not have any idea what these terminal boards should cost or a valid basis to

determine fair and reasonable prices. Table C-1 below summarizes the six terminal boards with historical or forecasted demand that had negotiated prices on Phase 1 of the contract, what pricing scenario was used to price each terminal board, the historical annual demand quantity, and contract unit price.

<b>Table C-1. Comparison of Terminal Boards</b>				
<b>Phase 1 Contract Prices</b>				
<u>NSN</u>	<u>Scenario</u>	<u>ADQ</u>	<u>Unit Cost</u>	<u>Annual price</u>
5940-00-606-5616	Catalog*	44	\$ 72.34	\$ 3,183
5940-00-615-8714	Vendor Quote	20	389.73	7,795
5940-00-856-0853	Catalog*	75	794.59	59,594
5940-01-006-0367	Price-Based	188	90.49	17,012
5940-01-057-3090	Price-Based	201	223.65	44,954
5940-01-058-3338	Price-Based	142	113.43	16,107
<b>Total</b>				<b>\$148,645</b>

\*Price analysis of the previous Government prices was performed to negotiate the prices for these items.

To illustrate the similarity of the form, fit, and function of these different terminal boards with significant price differences, we compared the terminal boards used on the E-3 and F-16 generators, and another terminal board used on an unknown military aircraft generator. The E-3 aircraft generator terminal board (NSN 5940-01-057-3090) has a negotiated contract unit price of \$223.65 and is constructed with a flat base with four prongs in a row protruding from the base. Figure C-5 below is a picture of the E-3 terminal board.

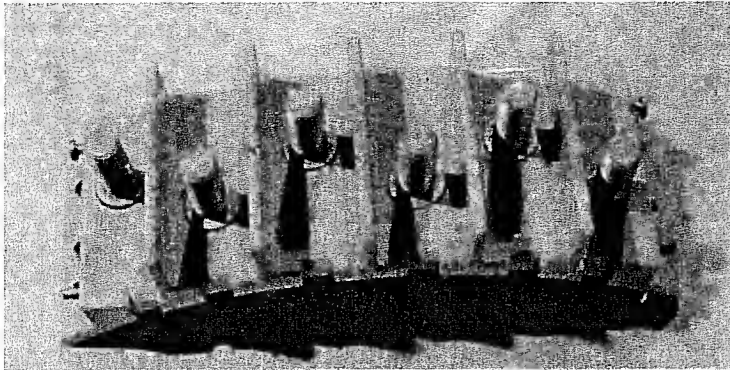


**Figure C-5. E-3 Terminal Board**  
**NSN 5940-01-057-3090**  
**Price-based**  
**Unit Price \$223.65 – ADQ 201**  
**Annual Price \$44,954**

The F-16 terminal board (NSN 5940-01-058-3338) had a negotiated contract unit price of \$113.43. Similar to the E-3 terminal board, the F-16 terminal board has a flat base and four prongs extending in a line from the base. However, the F-16 terminal board also has a tab that extends at an angle from the base on each end to attach the terminal board to the generator housing. The F-16 terminal board was shown previously in Figure C-1 (enlarged).

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A third terminal board (NSN 5940-00-856-0853) from an unknown aircraft generator had a negotiated contract unit price of \$794.59. This terminal board was different from the E-3 and F-16 terminal boards in that it has a curved base with six prongs, rather than a flat base with four prongs. Also, the prongs are not arranged in a straight line like the prongs for the E-3 and F-16 terminal boards. Figure C-6 below is a picture of this terminal board.



**Figure C-6. Terminal Board  
NSN 5940-00-856-0853  
Catalog  
Unit Price \$794.59 – ADQ 75  
Annual Price \$59,594**

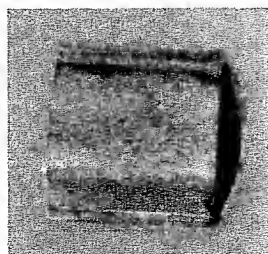
**Wedges.** We noticed similar pricing differences in 13 wedges with historical or forecasted demand that had negotiated prices on Phase 1 of the strategic sourcing contract with a combined annual price of \$380,724. Of the 13 wedges, 12 were priced using a vendor quote and one was priced using price analysis. As previously discussed, the vendor quotes Hamilton Sundstrand provided did not always contain economical quantity ranges, which resulted in higher negotiated prices.

For example, the wedge used on the A-10 generator (NSN 6150-01-503-6571) has an annual demand of 667 units, but the vendor only quoted a quantity range of 86–127 units. The F-16 generator wedge (NSN 6150-01-503-6572) has an annual demand of 868, but Hamilton Sundstrand provided a quote referencing a long-term agreement where all purchases are made at the same price, regardless of quantity. However, if the long-term agreement unit price is based on a low expected quantity, the price could be higher than necessary. For the other items, we did not review the quotes; as a result, we do not know whether the quoted quantities are economical or what prices were quoted.

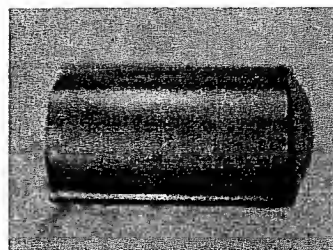
Table C-2 below shows the 13 wedges with historical or forecasted demand that had negotiated prices on Phase 1 of the contract, what pricing scenario was used to price each wedge, the historical annual demand quantity, and contract unit price.

<b>Table C-2. Comparison of Wedges Phase 1 Contract Prices</b>				
<u>NSN</u>	<u>Scenario</u>	<u>ADQ</u>	<u>Unit Cost</u>	<u>Annual price</u>
6150-01-399-8610	Vendor Quote	1,445	\$ 29.71	\$ 42,931
6150-01-503-6569	Vendor Quote	272	62.16	16,908
6150-01-503-6570	Vendor Quote	451	60.04	27,078
6150-01-503-6571	Vendor Quote	667	62.60	41,754
6150-01-503-6572	Vendor Quote	868	52.81	45,836
6150-01-503-6587	Vendor Quote	8,116	1.18	9,575
6150-01-503-6589	Vendor Quote	4,116	3.31	13,642
6150-01-503-6636	Price-Based	412	121.98	50,254
6150-01-503-6749	Vendor Quote	808	55.18	44,585
6150-01-503-7074	Vendor Quote	141	9.69	1,366
6150-01-503-8378	Vendor Quote	221	15.52	3,430
6150-01-505-8852	Vendor Quote	16,331	3.31	54,056
6150-01-505-8854	Vendor Quote	5,827	5.03	29,310
<b>Total</b>				<b>\$380,724</b>

We reviewed three of these wedges used on different aircraft generators. The F-16 generator wedge (NSN 6150-01-503-6572) had a negotiated contract unit price of \$52.81. A similar wedge used on the A-10 generator (NSN 6150-01-503-6571) had a negotiated contract unit price of \$62.60. The B-1B generator wedge (NSN 6150-01-503-6636) had a negotiated contract unit price of \$121.98. All three wedges are constructed of similar materials and all are used on the outside of the stack rotor for their respective generator to contain the wire wrapping within the stack rotor. The F-16 and A-10 generator wedges are similar in length, but the B-1B wedge is noticeably longer than the other two wedges. Both the F-16 and A-10 wedges were priced using questionable vendor quotes and have similar prices to each other at \$52.81 and 62.60, but the B-1B wedge was priced using price analysis and is nearly double the price at \$121.98. See Figures C-1.c and C-1.c.4 for a picture of the F-16 generator wedge. The figures below show pictures of the A-10 and B-1B wedges.



**Figure C-7. A-10 Generator Wedge**  
**NSN 6150-01-503-6571**  
**Unit Price \$62.60 – ADQ 667**  
**Annual Price \$41,754**



**Figure C-8. B-1B Generator Wedge**  
**NSN 6150-01-503-6636**  
**Unit Price \$121.98 – ADQ 412**  
**Annual Price \$50,254**

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Based on our review, cost analysis has proven to be the most effective method to establish fair and reasonable prices for military aircraft items.

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## **Appendix D. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition, Technology, and Logistics  
Director, Acquisition Resources and Analysis  
Under Secretary of Defense (Comptroller)/Chief Financial Officer  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)  
Director, Program Analysis and Evaluation  
Director, Defense Procurement and Acquisition Policy

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

Naval Inspector General  
Auditor General, Department of the Navy

### **Department of the Air Force**

Assistant Secretary of the Air Force (Acquisition)  
Assistant Secretary of the Air Force (Financial Management and Comptroller)  
Auditor General, Department of the Air Force  
Commander, Air Force Materiel Command  
Commander, Ogden Air Logistics Center  
Commander, Oklahoma City Air Logistics Center  
Commander, Warner Robins Air Logistics Center

### **Other Defense Organizations**

Director, Defense Logistics Agency  
Director, Defense Contract Audit Agency  
Director, Defense Contract Management Agency

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## **Non-Defense Federal Organization**

Office of Management and Budget

## **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Homeland Security and Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Government Reform  
House Subcommittee on Government Management, Finance, and Accountability,  
Committee on Government Reform  
House Subcommittee on National Security, Emerging Threats, and International  
Relations, Committee on Government Reform

# Under Secretary of Defense for Acquisition, Technology, and Logistics Comments



ACQUISITION,  
TECHNOLOGY  
AND LOGISTICS

OFFICE OF THE UNDER SECRETARY OF DEFENSE  
3000 DEFENSE PENTAGON  
WASHINGTON, DC 20301-3000

SEP 06 2006

MEMORANDUM FOR PRINCIPAL DIRECTOR FOR CONTRACTING,  
ACQUISITION AND CONTRACT MANAGEMENT,  
DODIG

THROUGH: DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS *RS 9/7/06*

SUBJECT: Response to DoDIG Draft Report D2005-D000CH-0183.000, "Commercial  
Contract for Noncompetitive Sparc Parts with Hamilton Sundstrand  
Corporation"

As requested, I am providing management comments (attached) on the subject report. I am very concerned about the pricing issues and practices at Hamilton Sundstrand identified in the report. I agree with the intent of your recommendations that DoD needs to improve application of cost and pricing techniques, especially on sole source commercial items. I have discussed my concerns with the Air Force Senior Procurement Executive and the actions needed to rectify the incorrectly priced items. In addition to addressing the specific issues identified in the draft report, I am taking actions to re-energize and improve the cost and pricing function across the Department. Five major actions are planned or underway that will address the issues identified in the draft report's recommendations.

1. **Meetings with Senior Procurement Executives (SPEs).** I met with each SPE separately and discussed my concerns about (i) the exceptional circumstances under which a waiver of the Truth In Negotiations Act is appropriate, and (ii) the need to assure that contractors provide sufficient cost or pricing data to determine a fair and reasonable price, with particular emphasis on commercial sole source situations.

2. **FAR Case.** The issues covered in the recommendations are included in our current deliberations under FAR Case No. 2005-036, Definition of Cost or Pricing Data.

3. **Revise the Procedures, Guidance, and Information (PGI).** While the FAR case is being worked I am taking more immediate steps to provide contracting personnel with procedures and/or guidance via the PGI which is a companion resource to the Defense Federal Acquisition Regulation Supplement (DFARS). These procedures will provide a more detailed discussion and clarification of the FAR requirements. This will include mandatory procedures regarding the need to obtain commercial sales



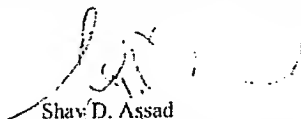
information and/or sufficient cost or pricing data to determine a fair and reasonable price, with particular emphasis on noncompetitive commercial item procurements. PGI is a resource containing mandatory and non-mandatory internal DoD procedures, guidance and supplemental information. The revised guidance and mandatory procedures will be communicated and re-emphasized to the DoD acquisition workforce through a policy memorandum that will be issued by December 8, 2006.

**4. DPAP Initiative to Re-energize the Cost Analysis and Pricing Function.**

DPAP will be re-energizing the cost analysis and price analysis functions within the Department. This will involve establishing a Cost, Price and Finance section within DPAP, performing a DoD wide pricing capabilities and resource assessment, initiating a DPAP outreach to buying activities, identifying weaknesses, providing contracting personnel with the tools and training necessary to improve our current cost and price analysis capabilities, and implementing any necessary regulatory, procedural, organizational and/or resource changes to improve cost and price analysis across the Department.

**5. Revising the Contract Pricing Reference Guide.** As part of the initiative to re-energize the cost analysis and pricing function, DPAP is currently in the process of updating the Contract Pricing Reference Guide. As part of this update, we will incorporate guidance to address, where appropriate, the recommendations identified in your report.

If you have any questions regarding this memorandum, please contact my point of contact, Mr. John McPherson, at 703-614-4840 or at [john.mcpherson@osd.mil](mailto:john.mcpherson@osd.mil).

  
Shay D. Assad  
Director, Defense Procurement  
and Acquisition Policy

Attachment:  
As stated

DoDIG Draft Report D2005-D000CH-0183.000

Recommendations:

1. *DoDIG Recommendation #A.1.* We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics develop and issue guidance in the acquisition regulations (Defense Federal Acquisition Regulation/Federal Acquisition Regulation) to:

a. Further clarify exceptions to cost or pricing data for noncompetitive commercial items that:

1. Address statutory requirements and provide instructions that contracting officers shall require submission of data other than certified cost or pricing data from the offeror or contractor. At a minimum, this data shall include appropriate information on the prices at which the same or similar items have previously been sold in the commercial market that is adequate for evaluating the reasonableness of the price of the procurement.

*DPAP Response. Concur.* We concur that there is a need to obtain adequate commercial sales data in accordance with FAR 15.403-3(a), Requiring Information Other Than Cost or Pricing Data. This provision states "...the contracting officer must require that the information submitted by the offeror include, at a minimum, appropriate information on the prices at which the same item or similar items have previously been sold, adequate for determining the reasonableness of the price...". FAR Case No. 2005-036 is currently reviewing the current FAR coverage to determine whether there is any needed clarification in relevant sections of FAR Subpart 15.4. DPAP will emphasize in the Procedures, Guidance and Information (PGI) the current FAR requirements that for sole source commercial procurements, contracting officers must obtain commercial sales, and if the commercial sales are not comparable to the items being purchased, obtain information other than cost or pricing data to include cost information. An exception would be when the contracting officer can verify and document that another agency recently performed a thorough cost or price analysis for the same item, and the contracting officer can rely on that analysis as the basis for determining a fair and reasonable price.

2. Establish Federal Acquisition Regulation 52-215.20 (ii)[sic], "Commercial Item Exception," as a mandatory contract requirement in Federal Acquisition Regulation Part 12 contracts.

*DPAP Response. Partially Concur.* FAR 15.408(l) currently requires the inclusion of the solicitation provision at FAR 52.215-20 in contracts for commercial and

noncommercial items when it is reasonably certain that cost or pricing data or information other than cost or pricing data will be required, but we do not feel that a change to FAR Part 12 is required. However, we recognize the importance of complying with the requirements currently contained in FAR 52.215-20, especially for sole-source items. Thus, we plan to emphasize in the PGI the importance of including this provision and requiring the contractor to submit cost or pricing data (or information other than cost or pricing data for a commercial item), when adequate commercial sales data was not submitted. We also concur with the intent that a commercial item exception to cost or pricing data should not be granted when a contractor fails to meet the conditions at provision 52.215-20(a)(1)(ii).

3. Instruct contracting officers to limit requests for information from the offeror or contractor on commercial sales to quantities similar to DoD annual demand quantities.

*DPAP Response. Concur.* We concur that contracting officers need to obtain commercial sales information that is comparable to the quantities anticipated in the solicitation. We will establish mandatory procedures stating that commercial sales used to determine price reasonableness must be representative of the quantities anticipated in the solicitation. The current FAR 15.403-3 directs the contracting officer to the Contract Pricing Reference Guide Section 3.3, Chapter 3, Volume I which contains significant guidance, to include comparing sales quantities, volumes.

4. Instruct appropriate Government officials to make a determination whether any "of a type" item is sufficiently similar to the military item and any difference in price can be identified and justified. Any significant difference in similarity or price should be supported by cost analysis.

*DPAP Response. Concur.* We agree that this area needs additional emphasis. The revisions to PGI and the update of the Contract Pricing Reference Guide will provide additional procedures and guidance for assessing "of a type" items to ensure the difference in price is identified and justified.

5. Instruct contracting officers to make a determination as to whether commercial sales information provided by the offeror or contractor is adequate to support a price reasonableness determination.

6. Instruct contracting officers to require additional "information other than cost or pricing data" from the offeror or contractor that includes cost information when the contracting officer makes a determination that commercial sales information is not adequate to support price reasonableness.

**DPAP Response. Concur.** DPAP will emphasize the current FAR requirements regarding this issue in a revision to PGI. This revision will establish mandatory procedures stating that, if the contractor cannot provide information on the prices at which the same or similar items have previously been sold in the commercial market that is adequate for evaluating the reasonableness of the price of the procurement (FAR 52.215-20(a)(1)(ii)), then a commercial item exception should not be granted. Under these conditions either cost or pricing data or information other than cost or pricing data to include cost information must be obtained. An exception would be when the contracting officer can verify and document that another agency performed a thorough cost or price analysis for the same item and uses that analysis as the basis for determining a fair and reasonable price.

b. Further clarify pricing of noncompetitive commercial items as required by the Storm Thurmond National Defense Authorization Act for Fiscal Year 1999 that:

1. Instructs contracting officers [to] perform price analysis of commercial sales, when sales of the same or similar item previously sold in the commercial market are adequate for evaluating through price analysis the reasonableness of price and ensure the integrity of commercial sales information.

**DPAP Response. Concur.** DPAP will emphasize the current FAR requirements at 15.403-3 and 15.404-1 and provide additional procedures regarding this determination in a revision to PGI. Specifically, we will include mandatory procedures requiring verification of commercial sales. Furthermore, if the contracting officer is relying on prior sales to the government, the basis of the cost or price analysis used to establish those prior sales must be verified and documented to ensure a proper and thorough analysis was performed.

2. Instructs contracting officers to obtain "information other than cost or pricing data" which includes cost information and perform cost analysis if commercial sales are not adequate to determine price reasonableness. Price analysis of the previous Government price is acceptable if recent cost analysis or competition was used to support the price and there have been no known changes in the manufacturing process that could significantly impact the contractor's costs.

**DPAP Response. Concur.** See responses to Recommendations a.5 and 6. and b.1. above.

2. **DoDIG Recommendation #A.2.** We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics address whether unreasonable and uncooperative contractors that refuse to provide either commercial sales information or "information other than cost or pricing data" to include cost information, should receive

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Red (unsatisfactory) out-of-cycle ratings in the Contractor Performance Assessment Reporting System under "Business Relations."

*DPAP Response. Concur.* FAR 15.403-3(a)(4), based on Section 808 of Public Law 105-261, already provides that an offeror who does not comply with a requirement to submit information other than cost or pricing data is ineligible for award unless the Head of the Contracting Agency (HICA) determines it is in the best interest of the government to make award to that offeror. Requiring a specific "unsatisfactory" rating would take away discretion that is needed in assessing past performance. In a separate memorandum on "Past Performance," DPAP will address "uncooperative contractors" and provide guidance that it may be appropriate to evaluate a contractor's past performance, in a regular or out of cycle evaluation, as unsatisfactory where a contractor refuses to provide commercial sales information or information other than cost or pricing data where the government feels this information is necessary in determining a fair and reasonable price. DPAP plans to issue the Past Performance memorandum by October 2, 2006.

# Assistant Secretary of the Air Force (Acquisition) Comments



DEPARTMENT OF THE AIR FORCE  
WASHINGTON DC

OFFICE OF THE ASSISTANT SECRETARY

JUL 31 2006

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL  
ATTN: DEPUTY INSPECTOR GENERAL FOR AUDITING

FROM: SAF/AQ

SUBJECT: Air Force Response to DoD IG Draft Report, Project No. D2005-D00CII-0183.000,  
Contract for Noncompetitive Spare Parts with Hamilton Sundstrand Corporation

This is in reply to your memorandum requesting that the Assistant Secretary of the Air Force provide comments on the subject draft report. The Air Force appreciates the opportunity to offer comments and recognizes the efforts of the DoD IG in its analysis and report preparation. In this era of ever-increasing global conflict and budget reductions within the Department, it is critical that we ensure every dollar being spent in support of the warfighter is spent wisely to assure accomplishment of the Air Force mission.

While we acknowledge that 24 items were incorrectly priced under the Phase I contract award, and have taken appropriate management action to correct the errors, the vast majority of the 1,011 items being procured were priced accurately. Our estimates for Air Force savings over the 9-year life of this contract exceed \$2.8 million, with an additional \$18.9 million savings when Defense Logistics Agency (DLA) line items are included.

Our responses to the draft recommendations are as follows:

**B.1. We recommend that the Assistant Secretary of the Air Force for Acquisition:**

**a. Initiate action to develop alternate sources for noncompetitive Hamilton Sundstrand items if the contractor fails to satisfy requirements for information other than cost or pricing data described in Recommendations B.2.**

**Air Force Response:** Concur. If Hamilton Sundstrand fails to provide adequate information necessary for the contracting officer to make a fair and reasonable price determination, the Assistant Secretary of the Air Force for Acquisition will request Ogden Air Logistics Center to initiate actions to develop alternate sources for the necessary items.

**b. Report the basis of commercial items determinations and steps taken to ensure price reasonableness for all Federal Acquisition Regulation Part 12 commercial contracts with an estimated value of \$15 million or more annually to the Secretary of Defense as required by the National Defense Authorization Act of Fiscal Year 2003.**

Air Force Response: Concur: The Air Force has consistently reported the basis of commercial items determinations and steps taken to ensure price reasonableness for all Federal Acquisition Regulation Part 12 commercial contracts with an estimated value of \$15 million or more annually to the Secretary of Defense as required by the National Defense Authorization Act of Fiscal Year 2003. DFARS Case 2003-D014 will provide further DFARS clarification concerning commercial contract reporting requirements for Indefinite Delivery/Indefinite Delivery contracts. The Air Force will continue to comply with the applicable commercial contract reporting requirements.

c. Provide assistance to the contracting officer and the Director of Contracting, Ogden Air Logistics Center, Hill Air Force Base, Utah, in obtaining cost information for 24 price based parts from Hamilton Sundstrand.

Air Force Response: Concur: If the contracting officer and the Director of Contracting, Ogden Air Logistics Center are unsuccessful in obtaining the requested cost information, the Assistant Secretary of the Air Force for Acquisition will provide assistance as appropriate.

The Air Force response to Recommendation B.2. addressed to the Commander, Ogden Air Logistics Center, Hill Air Force Base, UT, is provided as an attachment to this memorandum.

Point of contact for the Air Force response is: Ms. Kathleen James, SAF/AQCK, (703)588-7012, email: [kathleen.james@pentagon.af.mil](mailto:kathleen.james@pentagon.af.mil).



DONALD J. HOFFMAN, Lt Gen, USAF  
Military Deputy, Office of the Assistant Secretary  
of the Air Force (Acquisition)

Attachment:  
OO-ALC/CC Response

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OO-ALC Response to DoD IG Draft Report D2005-11000C11-0183.000

**B.2. We recommend that the Commander, Ogden Air Logistics Center, Hill Air Force Base, Utah, instruct the contracting officer for the strategic sourcing commercial contract with Hamilton Sundstrand to terminate the current pricing strategy and take the following actions:**

**Response.** Concur: Subsequent to the pricing of the phase 1 items, the Director of Contracting, Ogden Air Logistics Center, instructed the contracting officer not to utilize the existing pricing strategy for the pricing of the Phase 2 and 3 items.

a. Require submission of data other than certified cost or pricing data from the contractor that, at a minimum, should include appropriate information on the prices at which the same item or similar items have previously been sold in the commercial market that is adequate for evaluating the reasonableness of the price of the procurement.

**Response.** Partially Concur: The contracting officer is responsible for obtaining adequate information in order to determine a fair and reasonable price. If the contracting officer cannot obtain adequate information from sources other than the contractor, the contracting officer must require contractor submission of information other than cost or pricing data. This information must include existing information on the prices at which the same or similar items have been previously been sold.

When the contracting officer determined that adequate information from sources other than the contractor was not available, Hamilton Sundstrand provided past sales information where it existed. In those cases where adequate sales data did not exist, Hamilton Sundstrand provided additional information other than cost or pricing data to support their proposal.

b. Incorporate Federal Acquisition Regulation 52.215-20(ii), "Commercial Item Exception," in the contract.

**Response.** Partially Concur: In accordance with FAR 15.408(l), the contracting officer may insert the provision at 52.215-20 in solicitations where it is reasonably expected that cost or pricing data or information other than cost or pricing data may be required. Alternate IV shall be considered if an exception to cost or pricing data submission exists and submission of information other than cost or pricing data will be required.

FAR 52.215-20 is a solicitation provision, not a contract provision. The Hamilton Sundstrand solicitation did include the provision at FAR 52.215-20 and Alternate IV. Additionally, any future solicitations associated with this contract will include the provision at FAR 52.215-20 and Alternate IV as applicable.

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c. Limit requests for information from the contractor on commercial sales to quantities similar to DoD annual demand quantities.

**Response.** Partially concur: The annual demand quantities (ADQs) shown in the Hamilton Sundstrand contract are the government's best estimate at the time the contract was issued. However, these numbers are subject to change because of various conditions and circumstances that affect warfighter usage. The Hamilton Sundstrand contract is a Requirements contract that has quantity range pricing for each item. There may be instances in which the quantity ranges for a particular item are not consistent with the estimated ADQ, and the price of the item is quantity sensitive. If this occurs, and it is determined that the price ranges and/or pricing of a specific item is questionable due to a poorly estimated ADQ, the contracting officer will request that Hamilton Sundstrand mutually agree to reopen the pricing of the item(s). In addition, since all the items will be renegotiated every three years for option pricing purposes, the price ranges and prices of these items will be reviewed periodically.

d. Make a determination that any "of a type" commercial item is sufficiently similar to the military item and any difference in price can be identified and justified. Any significant difference in similarity or price should be supported by cost analysis.

**Response.** Partially Concur: It is inherent in the commerciality determination that the "similar to" commercial item is sufficiently similar to the "of a type" military item. However, the difference in similarity or price may be supported by either price analysis or cost analysis techniques depending on the availability and adequacy of information (which includes existing information on prices at which the same items have previously been sold). The requirement is to ensure appropriate cost or pricing techniques are executed to ensure the price is fair and reasonable, which was done on the Hamilton Sundstrand contract.

e. Make a determination as to whether commercial sales information provided by the contractor is adequate to support a price reasonableness determination.

**Response.** Concur: It is inherent in the contracting officer's price reasonableness determination that adequate information was obtained to support the determination. If the contracting officer cannot obtain adequate information from sources other than the offeror, the contracting officer must require submission of information other than cost or pricing data from the offeror that is adequate to determine a fair and reasonable price. This information must include existing information on the prices at which the same or similar items have been previously sold. If sales data is inadequate or does not exist, the contracting officer must request additional information other than cost or pricing data. By definition, if the contracting officer has determined a price to be fair and reasonable and this determination is based on sales data, then the sales data was adequate to support the determination. The requirement is to ensure appropriate cost or pricing

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techniques are executed to ensure the price is fair and reasonable. This is the process utilized in pricing the instant Hamilton Sundstrand contract.

f. Require "information other than cost or pricing data" from the contractor which includes cost information when the contracting officer makes a determination that commercial sales information is not adequate to support price reasonableness.

Response. Partially Concur: If the contracting officer cannot obtain adequate information from sources other than the contractor, the contracting officer must require contractor submission of information other than cost or pricing data. Information other than cost or pricing data is any type of information that is necessary to determine price reasonableness. Sales history information, including previous sales to the government, is one form of information other than cost or pricing data. If sales history is not sufficient to perform an adequate price analysis, the contracting officer is required to request additional information other than cost or pricing data. The additional information other than cost or pricing data may include cost information if deemed necessary by the contracting officer to determine price reasonableness. This hierarchy was used in pricing the Hamilton Sundstrand contract.

g. Perform price analysis of commercial sales, when sales of the same or similar item previously sold in the commercial market are adequate for evaluating, through price analysis, the reasonableness of price and ensure the integrity of commercial sales information.

Response. Concur: When adequate and relevant sales data is available, the contracting officer utilizes this information in performance of a price analysis to support a price reasonableness determination. The requirement is to ensure appropriate cost or pricing techniques are executed to ensure the price is fair and reasonable. The contracting officer for the Hamilton Sundstrand contract considered available and relevant sales data in performing the price analysis supporting the price reasonableness determination.

h. Perform cost analysis of uncertified cost or pricing data if commercial sales are not adequate to determine price reasonableness. Price analysis of the previous Government price is acceptable if recent cost analysis or competition was used to support the price and there have been no known changes in the manufacturing process that could significantly impact the contractor's costs.

Response. Concur: If the contracting officer cannot obtain adequate information from sources other than the contractor, the contracting officer must require contractor submission of information other than cost or pricing data. This information must include existing information on the prices at which the same or similar items have been previously been sold. If adequate sales data does not exist, the contracting officer must request additional information other than cost or pricing data, which may include cost data. When cost data is received, a cost analysis is performed by the contracting officer. The requirement is to ensure appropriate cost or pricing techniques are executed to ensure the price is fair and reasonable, which was done on this contract.

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In the instant Hamilton Sundstrand contract, when the contracting officer determined that adequate information from sources other than the contractor was not available, Hamilton Sundstrand provided past sales information where it existed. In those cases where adequate sales data did not exist, Hamilton Sundstrand provided additional information other than cost or pricing data to support their proposal. When this additional information included cost data, a cost analysis was performed.

i. Address economic order quantities on any vendor quotes for purchased parts.

Response. Concur: Economic order quantity information can have a significant impact on final negotiated prices. The Phase 1 negotiated prices did consider quantity price sensitivity compared to estimated requirements. As expected, some items were more quantity sensitive than others. As time has proceeded, some quantity estimates have been more accurate than others, thus potentially affecting quantity discounts. Hamilton Sundstrand will be requested to provide this information as appropriate to support the applicable Phase 2 and 3 negotiated prices.

j. Discontinue pricing items with no forecasted or historical demand until an actual requirement exists.

Response. Partially concur: Generally, pricing of items with no forecasted or historical demand may not yield results that are reflective of actual pricing for such items at the time of demand, so should be done only in cases where the Government is reasonably certain the benefit will outweigh the time and effort involved. For the items in question, this was a conscious decision made during the acquisition planning phase of this effort. In order to reduce lead times for potential items that may be needed to support the warfighter, there were items included in the contract that did not have any historical or forecasted demand. The additional burden associated with adding these items now was insignificant compared to the time and effort that would be required to procure these items after the critical need was identified.

k. Request the Defense Contract Management Agency, Windsor Locks, Connecticut:

1. Validate negotiated Phase 1 prices for purchased parts to determine cost realism of vendor quotes that did not address economic order quantities and adjust contract prices if necessary.

2. Review contractor "estimated cost information" for the accessory drive gearbox housing for the F-16 turbine engine (national stock number 2835-01-208-4430) in the next year or two if demand increases as planned and adjust the contract price if necessary.

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3. Review contractor "estimated cost information" for items manufactured in Puerto Rico after manufacturing standards have been audited and adjust the contract price if necessary.

4. Review cost information requested by the Director of Contracting, Ogden Air Logistics Center, Hill Air Force Base, Utah, for 24 price-based parts to substantiate the negotiated prices and adjust contract prices if necessary.

Response. Concur: If the various reviews indicate inflated contract prices, the contracting officer will request that Hamilton Sundstrand mutually agree to a price reduction. If Hamilton Sundstrand is unwilling to agree to a price reduction, the contracting officer may take several actions including elevating the issue to higher Air Force management levels, initiating action to obtain an alternate source, and consider whether a contract termination for convenience is in the government's best interests.

1. Determine whether Hamilton Sundstrand should receive a Red (unsatisfactory) out-of-cycle Contractor Performance Assessment Reporting System report rating in "Business Relations," if the contractor behavior continues to be unreasonable or uncooperative in meeting any of the data requests outlined in the previous recommendations.

Response. Concur: If it is determined that Hamilton Sundstrand is unreasonable or uncooperative with regards to providing data that is required by regulation and/or statute and necessary for the contracting officer to determine a fair and reasonable price, an unsatisfactory (Red) rating for the "Business Relations" category of its Contractor Performance Assessment Reporting System (CPARS) evaluation will be considered.

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# Assistant Secretary of the Air Force (Acquisition) Technical Corrections



DEPARTMENT OF THE AIR FORCE  
WASHINGTON, DC

SEP 28 2006

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDITING  
OFFICE OF THE INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE


FROM: SAF/AQC  
1060 Air Force Pentagon  
Washington, DC 20330-1060

SUBJECT: Technical Corrections to Initial Air Force Response to DoDIG Draft Report,  
Project Number, D2005-D00CH-0183.000, Contract for Noncompetitive Spare  
Parts with Hamilton Sundstrand Corporation

This is in reply to your request for technical corrections to the initial Air Force Response to subject draft audit.

We appreciate the opportunity to provide these technical corrections, which we believe, improve and strengthen the overall quality of the Air Force Response. The corrections are provided in the attachment hereto and address both the SAF/AQ responses and the associated Ogden Air Logistics Center responses. Earlier responses, which have not been changed, are not included in this package.

If you have any questions regarding this matter, please contact our new action officer, Randall Culpepper, SAF/AQCP at (703) 588-7053 or email him at [Randall.culpepper@pentagon.af.mil](mailto:Randall.culpepper@pentagon.af.mil).

  
CHARLIE F. WILLIAMS, JR.  
Deputy Assistant Secretary (Contracting)  
Assistant Secretary (Acquisition)

Attachment:  
SAF/AQC Technical Corrections to  
DoDIG Draft Report D2005-D00CH-0183.000

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SAF/AQC TECHNICAL CORRECTIONS TO  
DODIG DRAFT REPORT D2005-D00CH-0183.000

SAF/AQC provides the following amended response to SAF/AQ ltr dtd 31 Jul 2006.

B.1. We recommend that the Assistant Secretary of the Air Force for Acquisition:

b. Report the basis of commercial items determinations and steps taken to ensure price reasonableness for all Federal Acquisition Regulation Part 12 commercial contracts with an estimated value of \$15 million or more annually to the Secretary of Defense as required by the National Defense Authorization Act of Fiscal Year 2003.

Air Force Response: Concur: The Air Force has consistently reported the basis of commercial item determinations and steps taken to ensure price reasonableness for all Federal Acquisition Regulation Part 12 commercial contracts with an estimated value of \$15 million or more annually to the Secretary of Defense as required by the National Defense Authorization Act of Fiscal Year 2003. DFARS Case 2003-D014 has been opened for the purpose of providing further DFARS clarification concerning commercial contract reporting requirements for Indefinite Delivery/Indefinite Quantity contracts. The Air Force fully intends to comply with existing commercial contract reporting requirements for the Hamilton Sundstrand contract for the immediate future and all revisions to that guidance that are published in the future.

SAF/AQC provides the following amended responses to OO-ALC Response attached to SAF/AQ ltr dtd 31 Jul 2006.

OO-ALC Response to DoD IG Draft Report D2005-D000CH-0183.000

B.2. We recommend that the Commander, Ogden Air Logistics Center, Hill Air Force Base, Utah, instruct the contracting officer for the strategic sourcing commercial contract with Hamilton Sundstrand to terminate the current pricing strategy and take the following actions:

Response: Concur: Subsequent to the pricing of the phase 1 items, the Director of Contracting, Ogden Air Logistics Center, instructed the contracting officer not to utilize the existing pricing strategy for the pricing of the Phase 2 and 3 items.

a. Require submission of data other than certified cost or pricing data from the contractor that, at a minimum, should include appropriate information on the prices at which the same item or similar items have previously been sold in the commercial market that is adequate for evaluating the reasonableness of the price of the procurement.

Response: Partially Concur: It is acknowledged that the contracting officer is responsible for obtaining adequate information in order to determine a fair and reasonable price. Accordingly, in phases 2 and 3, Hamilton Sundstrand will be required to provide commercial market sales data

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adequate for evaluating the reasonableness of the price where appropriate, including data on sales for the same or similar to items in quantities similar to Air Force and Defense Logistics Agency demand quantity requirements. If the data submitted is not sufficient for determining the price to be fair and reasonable, then the contracting officer will look at data available from other sources in an effort to justify the prices offered and verify that sufficient cost or price analysis was performed on the previous price to determine prices fair and reasonable. If the contracting officer cannot obtain adequate information from sources other than the contractor, then the contracting officer will require the contractor to submit information other than cost or pricing data including existing information on the prices at which the same or similar items may have been previously sold.

During Phase 1, when the contracting officer determined that adequate information from sources other than the contractor was not available, Hamilton Sundstrand provided past sales information where it existed. In those cases where adequate sales data did not exist, Hamilton Sundstrand provided additional information other than cost or pricing data in support of their proposal.

**b. Incorporate Federal Acquisition Regulation 52.215-20(ii), "Commercial Item Exception," in the contract.**

**Response.** Partially Concur: In accordance with FAR 15.408(l), the contracting officer may insert the provision at 52.215-20 in solicitations where it is reasonably expected that cost or pricing data or information other than cost or pricing data may be required. The Hamilton Sundstrand solicitation did include the provisions at FAR 52.215-20 and Alternate IV. As FAR 52.215-20 is a solicitation provision, not a contract provision, and Phases 2 and 3 that remain under this contract do not require a formal solicitation, the contracting officer will issue letters requesting pricing for Phases 2 and 3. These letters will require submission of commercial sales data, at a minimum, to include (where available) information on prices at which the same item or similar items have been sold previously in the commercial market. Where adequate sales data is obtained, the contracting officer will use that sales data in determining price reasonableness. Where adequate sales data sufficient to support pricing efforts cannot be obtained, the contracting officer will seek data from sources other than the contractor to price those items. When data from other sources is not sufficient to support pricing efforts the contracting officer will request submission of information other than cost or pricing data by Hamilton Sundstrand.

**c. Limit requests for information from the contractor on commercial sales to quantities similar to DoD annual demand quantities.**

**Response.** Concur. We agree that commercial market sales information for the same or similar to items should be obtained in quantities similar to DoD annual demand quantities to ensure a suitable comparison for establishing prices. The annual demand quantities (ADQs) shown in the Hamilton Sundstrand contract represent the government's best estimate at the time of contract award. However, these numbers were subject to change as a result of conditions and circumstances affecting warfighter usage. As the Hamilton Sundstrand contract is a Requirements contract which has quantity range pricing for each of the many items, there were instances in which the quantity ranges for a particular item were not consistent with the estimated ADQ. When this is true and the price of the item is quantity sensitive, and it is

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determined that the price ranges and/or pricing of a specific item is questionable, the contracting officer will request that Hamilton Sundstrand mutually agree to reopen the pricing of the item(s). In addition, since all the items are due to be renegotiated every three years for option pricing purposes, the price ranges and prices of these items will be reviewed periodically.

**d. Make a determination that any "of a type" commercial item is sufficiently similar to the military item and any difference in price can be identified and justified. Any significant difference in similarity or price should be supported by cost analysis.**

**Response.** Partially Concur. We will assess "of a type" commercial items considered for Phases 2 and 3 of the contract and ensure adequate similarity to the military item. We will also support any significant price difference between the military and commercial "of a type" items in accordance with existing FAR provisions prescribed for cost and price analysis. If commercial sales of the "of a type" item are not sufficient to determine price reasonableness, information other than cost or pricing data will be requested. Cost analysis will be conducted during pricing efforts when other methods of supporting the pricing efforts are unsuccessful.

**e. Make a determination as to whether commercial sales information provided by the contractor is adequate to support a price reasonableness determination.**

**Response.** Concur. It is inherent in the contracting officer's price reasonableness determination that adequate information be obtained to support the determination. If the contracting officer cannot obtain adequate information from sources other than the offeror, the contracting officer must require submission of information other than cost or pricing data from the offeror that is adequate to determine a fair and reasonable price. This information must include existing information on the prices at which the same or similar items have been previously been sold. Where adequate sales data is obtained, the contracting officer will use that sales data in determining price reasonableness. If sales data is inadequate or does not exist, the contracting officer must request additional information other than cost or pricing data. The contracting officer's determination that the price is fair and reasonable is the result of a rational judgment that all available data is sufficient to lead to an affirmative conclusion of a fair and reasonable price.

**f. Require "information other than cost or pricing data" from the contractor which includes cost information when the contracting officer makes a determination that commercial sales information is not adequate to support price reasonableness.**

**Response.** Partially Concur. If the contracting officer cannot obtain adequate information from sources other than the contractor, the contracting officer must and will require contractor submission of information other than cost or pricing data. Information other than cost or pricing data is any type of information that is necessary to help in determining price reasonableness such as sales history information, including previous sales to the government. If sales history is not sufficient to permit performance of an adequate price analysis, the contracting officer will request additional information other than cost or pricing data. The additional information other than cost or pricing data may include cost information if deemed necessary by the contracting

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officer to determine price reasonableness. This hierarchy as defined in FAR 15.402(a) was used in pricing the Hamilton Sundstrand contract.

g. Perform price analysis of commercial sales, when sales of the same or similar item previously sold in the commercial market are adequate for evaluating, through price analysis, the reasonableness of price and ensure the integrity of commercial sales information.

Response. Concur: When adequate and relevant sales data is available, the contracting officer will utilize this information during Phases 2 and 3 to ensure integrity of commercial sales information and perform price analysis in support of price reasonableness determinations.

h. Perform cost analysis of uncertified cost or pricing data if commercial sales are not adequate to determine price reasonableness. Price analysis of the previous Government price is acceptable if recent cost analysis or competition was used to support the price and there have been no known changes in the manufacturing process that could significantly impact the contractor's costs.

Response. Concur: If the contracting officer cannot obtain adequate information from sources other than the contractor during Phases 2 and 3 of the contract, the contracting officer must and will require contractor submission of information other than cost or pricing data. This information must include existing information on the prices at which the same or similar items have been previously sold. If adequate sales data does not exist, the contracting officer must request additional information other than cost or pricing data, which may include cost data. When cost data is received, a cost analysis will be performed by the contracting officer. The contracting officer will ensure appropriate cost or pricing techniques are executed to ensure the price is fair and reasonable.

During Phase 1 when the contracting officer determined that adequate information from sources other than the contractor was not available, Hamilton Sundstrand provided past sales information where it existed. In those cases where adequate sales data did not exist, Hamilton Sundstrand provided additional information other than cost or pricing data to support their proposal. When this additional information included cost data, a cost analysis was performed.

i. Address economic order quantities on any vendor quotes for purchased parts.

Response. Concur: Economic order quantity information can have a significant impact on final negotiated prices. The Phase 1 negotiated prices did consider quantity price sensitivity compared to estimated requirements. As expected, some items were more quantity sensitive than others. As time has proceeded, some quantity estimates have been more accurate than others, thus potentially affecting quantity discounts. Hamilton Sundstrand will be requested to provide accumulated historical information as appropriate to support the applicable Phase 2 and 3 pricing efforts and subsequent negotiations to ensure the quantity sensitivity of items is recognized.

j. Discontinue pricing items with no forecasted or historical demand until an actual requirement exists.

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**Response.** Partially concur: Generally, pricing of items with no forecasted or historical demand may not yield results that are reflective of actual pricing for such items at the time of demand, so should be done only in cases where the Government is reasonably certain the benefit will outweigh the time and effort involved. For the items in question, this was a conscious decision made during the acquisition planning phase of this effort. In order to reduce lead times for potential items that may be needed to support the warfighter, there were items included in the contract that did not have any historical or forecasted demand. The additional burden associated with adding these items now were insignificant compared to the time and effort that would be required to procure these items after the critical need was identified.

k. Request the Defense Contract Management Agency, Windsor Locks, Connecticut:

1. Validate negotiated Phase 1 prices for purchased parts to determine cost realism of vendor quotes that did not address economic order quantities and adjust contract prices if necessary.

2. Review contractor "estimated cost information" for the accessory drive gearbox housing for the F-16 turbine engine (national stock number 2835-01-208-4430) in the next year or two if demand increases as planned and adjust the contract price if necessary.

3. Review contractor "estimated cost information" for items manufactured in Puerto Rico after manufacturing standards have been audited and adjust the contract price if necessary.

4. Review cost information requested by the Director of Contracting, Ogden Air Logistics Center, Hill Air Force Base, Utah, for 24 price-based parts to substantiate the negotiated prices and adjust contract prices if necessary.

**Response.** Concur: The contracting officer will pursue completion of the various recommended reviews by Defense Contract Management Agency, Windsor Locks, Connecticut and will provide status regarding the reviews by 31 Jan 2007. If indications surface that reveal inflated contract prices as the various reviews are completed, the contracting officer will request that Hamilton Sundstrand mutually agree to a price reduction. If Hamilton Sundstrand is unwilling to agree to a price reduction, the contracting officer may take several actions including elevating the issue to higher Air Force management levels, initiating action to obtain an alternate source, and consider whether a contract termination for convenience is in the government's best interests.

l. Determine whether Hamilton Sundstrand should receive a Red (unsatisfactory) out-of-cycle Contractor Performance Assessment Reporting System report rating in "Business Relations," if the contractor behavior continues to be unreasonable or uncooperative in meeting any of the data requests outlined in the previous recommendations.

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Response. Concur: If it is determined that Hamilton Sundstrand is unreasonable or uncooperative with regards to providing data that is required by regulation and/or statute and necessary for the contracting officer to determine a fair and reasonable price, an unsatisfactory (Red) rating for the "Business Relations" category of its Contractor Performance Assessment Reporting System (CPARS) evaluation will be considered.

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## **Team Members**

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